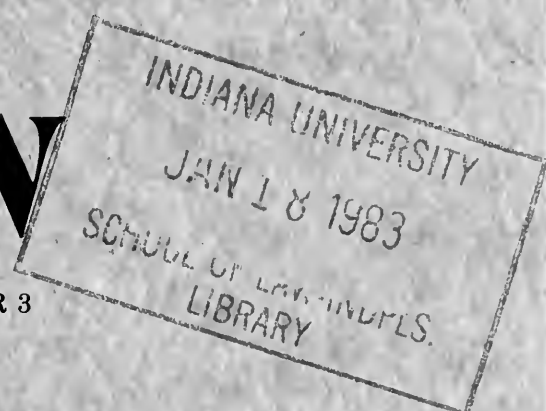


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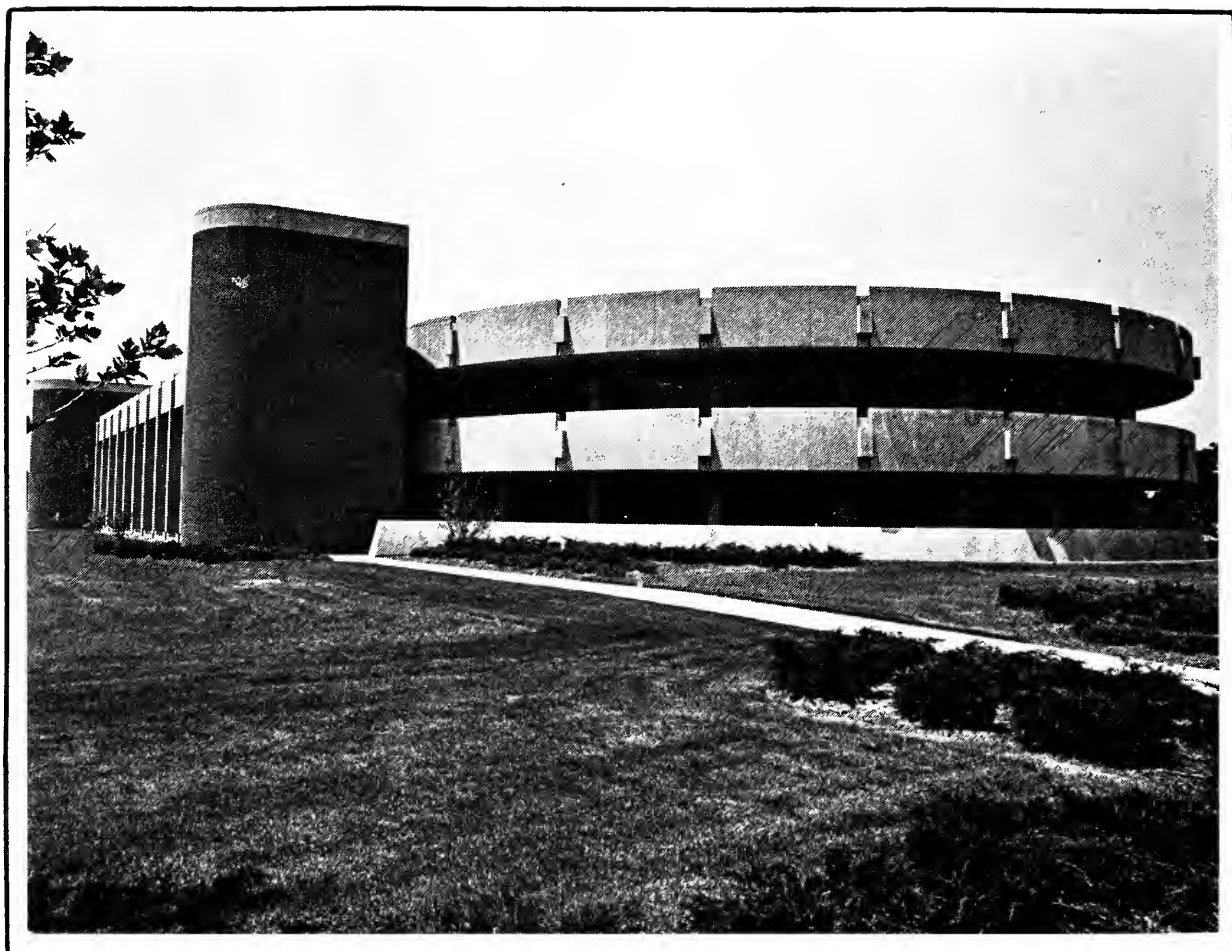
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Intentionally and Negligently Inflicted Emotional Distress: Toward a Coherent Reconciliation

DAVID B. MILLARD*

In *Elza v. Liberty Loan Corp.*,¹ the Indiana Supreme Court refused to review a Second District Indiana Court of Appeals decision² which reached what has been characterized as "an unprecedented result"³ when it required contemporaneous physical impact as a necessary condition to recovery for intentionally inflicted emotional distress.⁴ Although the Indiana Supreme Court's denial of transfer and the unpublished memorandum decision of the court of appeals are without authority as precedent,⁵ these decisions come perilously close to contaminating this area of the law⁶ with the much maligned plaintiff "impact rule."⁷

*B.S. 1977, J.D. 1979, Indiana University. Associate of Dutton, Kappes & Overman, Indianapolis, Indiana.

¹426 N.E.2d 1302 (Ind. 1981).

²*Elza v. Liberty Loan Corp.*, No. 2-1180-A-371 (Ind. Ct. App. Apr. 30, 1981).

³*Elza v. Liberty Loan Corp.*, 426 N.E.2d 1302, 1308 (Ind. 1981) (Hunter, J., dissenting).

⁴*Elza v. Liberty Loan Corp.*, No. 2-1180-A-371 (Ind. Ct. App. Apr. 30, 1981).

⁵IND. R. APP. P. 11(B)(4) provides that a denial of a petition to transfer has "no legal effect other than to terminate the litigation between the parties in the Supreme Court." IND. R. APP. P. 15(A)(3) provides that an unpublished memorandum decision shall not "be regarded as precedent nor cited before any court except for the purpose of establishing the defense of res judicata, collateral estoppel or the law of the case."

⁶Indiana presently requires a contemporaneous physical impact on the plaintiff as a prerequisite to recovery for negligently inflicted emotional distress. *Boston v. Chesapeake & O. Ry.*, 223 Ind. 425, 61 N.E.2d 326 (1945); *Kroger Co. v. Beck*, 375 N.E.2d 640 (Ind. Ct. App. 1978); *Kalen v. Terre Haute & I.R.R.*, 18 Ind. App. 202, 47 N.E. 694 (1897).

⁷The "impact rule" provides that there can be no recovery for emotional distress when there has been no immediate physical impact to the plaintiff. See W. PROSSER, *HANDBOOK OF THE LAW OF TORTS* § 54, at 328-30 (4th ed. 1971). See also Note, *Recovery for Negligent Infliction of Emotional Distress: Changing the Impact Rule in Indiana*, 54 IND. L.J. 467 (1979) (hereinafter cited as *Negligent Infliction Note*) for a critique of the impact rule as it has been applied in negligent infliction of emotional distress cases.

In *Kroger Co. v. Beck*,⁸ the Third District Indiana Court of Appeals, in dictum, criticized the impact rule and indicated that it may not be the soundest possible rule.⁹ In an unpublished opinion concurring with the decision of the Indiana Court of Appeals in *Elza*, Judge Sullivan opined that it would be appropriate for the Indiana Supreme Court to reconsider the propriety of the impact rule in light of the current law in other jurisdictions recognizing a right to recover for intentionally inflicted emotional distress absent physical impact to the plaintiff.¹⁰ This author has advanced what Justice Hunter of the Indiana Supreme Court, dissenting to the denial of transfer in *Elza*, has characterized as "persuasive arguments for the abrogation of the rule"¹¹

In spite of this trend toward rejecting the impact rule, Indiana remains with the ranks of five out of this nation's fifty-one jurisdictions which still require impact as a prerequisite to recovery for negligently inflicted emotional distress.¹² The Indiana Supreme Court's refusal of transfer in *Elza* not only permits the court's adherence to the impact rule to stand, but also indicates that it is prepared to allow Indiana to become one of the only jurisdictions in the nation to require a contemporaneous physical impact to the plaintiff as a prerequisite to recovery for intentionally inflicted emotional distress. This Article discusses the law of intentional and negligent infliction of emotional distress, both in terms of the confusing and volatile state of Indiana law and the different treatment which these two areas have received in this and other countries. These different treatments are analyzed and challenged, and

⁸375 N.E.2d 640 (Ind. Ct. App. 1978).

⁹*Id.* at 645 n.5. *Kroger* dealt with negligent infliction of emotional distress.

¹⁰No. 2-1180-A-371 (Ind. Ct. App. Apr. 30, 1981) (Sullivan, J., concurring).

¹¹426 N.E.2d 1302, 1308 (Ind. 1981) (Hunter, J., dissenting) (citing *Negligent Infliction* Note which advocated abrogation of the impact requirement as a condition necessary to recovery for negligently inflicted emotional distress).

¹²See *Butchikas v. Travelers Indemn. Co.*, 343 So. 2d 816 (Fla. 1977); *Howard v. Bloodworth*, 137 Ga. App. 478, 224 S.E.2d 122 (1976); *Kroger Co. v. Beck*, 375 N.E.2d 640 (Ind. Ct. App. 1978); *Louisville & N.R. Co. v. Roberts*, 207 Ky. 310, 269 S.W. 333 (1925); *McCardle v. George B. Peck Dry Goods Co.*, 191 Mo. App. 263, 177 S.W. 1095 (1915). The number of jurisdictions following the impact rule continues to dwindle. The Illinois Court of Appeals has most recently rejected the impact rule, characterizing it as an arbitrary and obsolete rule which bars meritorious claims, and stating that "the subsequent history of the impact rule and the development of the law in areas dealing with mental distress convince us that a reevaluation of the rule is proper. . . . [T]he rationales underlying the impact rule have been rejected as unsound . . . by the vast majority of jurisdictions" *Rickey v. Chicago Transit Auth.*, 428 N.E.2d 596, 598 (Ill. Ct. App. 1981). Colorado and Massachusetts have also recently abandoned the impact requirement. *Towns v. Anderson*, 579 P.2d 1163 (Colo. 1978); *Dziokonski v. Babineau*, 375 Mass. 555, 380 N.E.2d 1295 (1978).

an approach is recommended which rationalizes and reconciles these two differently treated but very similar areas of the law.

I. INDIANA LAW

The *Elza* decisions, being without precedential value,¹³ have left Indiana law respecting the right to recover for intentionally inflicted emotional distress in a state of confusion.¹⁴ In *Elza*, an employee of Liberty Loan Corporation, while inside the Elza home trying to collect a debt, called Broderick Elza a "lying little punk" and told Broderick to meet him "behind Liberty Loan at 6:00." Elza asked the Liberty Loan employee to leave the house, whereupon the employee, with Elza's wife and children watching from ten feet away, shoved Elza against the sink, counter and cabinets, stuck his finger in Elza's face, and beat upon Elza's chest, telling Elza to "meet him later" so he could "finish" him. Elza's wife and children sought damages for the mental distress they suffered as a result of watching the Liberty Loan employee batter Elza.¹⁵ The trial court held that the allegations in the complaint along with the answers to interrogatories did not satisfy the Indiana impact requirement, therefore, no genuine issue of fact existed.¹⁶

Elza's wife and children advanced three arguments to the Indiana Court of Appeals in support of their case. They first argued that Indiana recognizes intentional infliction of emotional distress as an independent tort. Alternatively, they urged the court to overrule existing case law and recognize the tort of intentional infliction of mental distress. Third, they argued that their claims fell within the recognized intentional infliction of emotional distress exception to the impact rule.¹⁷ The Indiana Court of Appeals refused to recognize the tort of intentional infliction of emotional distress and held that the only exception to the impact rule requires a host action in the form of a tort directed to or committed against the claimant when it appears that, either from the type of host tort or the means or manner by which it is committed, there is a likelihood emotional distress will follow.¹⁸ The court of appeals based its characterization of Indiana law, as requiring an impact prerequisite to recovery for inten-

¹³See note 5 *supra* and accompanying text.

¹⁴Indiana law respecting the right to recover for negligently inflicted emotional distress is much clearer. Indiana requires a contemporaneous physical impact in order to recover for negligently inflicted emotional distress. See note 6 *supra*.

¹⁵*Elza v. Liberty Loan Corp.*, 426 N.E.2d 1302, 1303 (Ind. 1981) (Hunter, J., dissenting).

¹⁶*Elza v. Liberty Loan Corp.*, No. 2-1180-A-371, slip op. at 2 (Ind. Ct. App. Apr. 30, 1981).

¹⁷*Id.*

¹⁸*Id.* at 2-5.

tionally inflicted emotional distress, on *Boden v. Del-Mar Garage, Inc.*¹⁹ in which the Indiana Supreme Court addressed a claim for intentionally inflicted emotional distress.²⁰

It is open to serious question whether *Boden* is dispositive of *Elza*.²¹ In *Boden*, the plaintiff sought recovery for the emotional distress she sustained by watching a driver intentionally knock down and injure plaintiff's husband with an automobile.²² The Indiana Supreme Court upheld the trial court's dismissal, albeit without citation to authority, on the basis that there was no contemporaneous physical impact to her.²³ At the time of the *Boden* decision there were numerous Indiana cases directly contrary to the supreme court's position.²⁴ These cases stand for the proposition that recovery of damages for mental distress in tort actions does not require proof of contemporaneous physical impact when the defendant's conduct was intentional and should reasonably have been anticipated to provoke a severe emotional disturbance.²⁵ Three of the cases involved intentional misconduct in which third party family members were permitted to recover for their mental distress.²⁶

Boden has never before been cited as authority for the question in *Elza*.²⁷ Post-*Boden* appellate courts have continued to recognize the pre-*Boden* rule as controlling.²⁸ The subsequent lack of citation of *Boden* as authority may be explained by *Boden's* reliance on the then prevailing view of a married woman's legal status which limited her right to sue as an individual.²⁹ The Indiana Supreme

¹⁹205 Ind. 59, 185 N.E. 860 (1933).

²⁰No. 2-1180-A-371, slip op. at 3-4; *id.* at 6 (Sullivan, J., concurring).

²¹426 N.E.2d at 1303 (Hunter, J., dissenting).

²²205 Ind. at 60-61, 185 N.E. at 860-61.

²³*Id.* at 70-72, 185 N.E. at 864.

²⁴See *Montgomery v. Crum*, 199 Ind. 660, 161 N.E. 251 (1928) (abduction of plaintiff's child gives rise to compensable injuries for mental distress); *Harness v. Steele*, 159 Ind. 286, 64 N.E. 875 (1902) (false arrest and imprisonment gives rise to compensable injuries for humiliation and mortification); *Kline v. Kline*, 158 Ind. 602, 64 N.E. 9 (1902) (assault gives rise to compensable injuries for fright and mental anguish); *Pennsylvania Co. v. Bray*, 125 Ind. 229, 25 N.E. 439 (1890) (wrongful ejection from train gives rise to compensable injury for indignity); *Felkner v. Scarlet*, 29 Ind. 154 (1867) (seduction of daughter gives rise to compensable injuries for family dishonor and injured feelings); *Pruitt v. Cox*, 21 Ind. 15 (1863) (seduction of daughter gives rise to compensable mental distress).

²⁵See note 24 *supra*.

²⁶See *Montgomery v. Crum*, 199 Ind. 660, 161 N.E. 251 (1928); *Felkner v. Scarlet*, 29 Ind. 154 (1867); *Pruitt v. Cox*, 21 Ind. 15 (1863).

²⁷426 N.E.2d at 1305 (Hunter, J., dissenting).

²⁸See, e.g., *Charlie Stuart Oldsmobile, Inc. v. Smith*, 171 Ind. App. 315, 357 N.E.2d 247 (1976), *modified on other grounds*, 369 N.E.2d 947 (Ind. Ct. App. 1977); *Aetna Life Ins. Co. v. Burton*, 104 Ind. App. 576, 12 N.E.2d 360 (1938).

²⁹See 205 Ind. 59, 185 N.E. 860 (1933).

Court later overruled *Boden* on the question of whether a wife could recover for loss of consortium³⁰ and specifically rebuked the limited view of a married woman's legal status to sue as an individual.³¹

Thus, the case upon which the Indiana Court of Appeals in *Elza* relied in attempting to extend the impact rule into the area of intentional infliction of emotional distress is of questionable precedential value for the proposition cited. The statement made by the Second District Court of Appeals in *Elza* that the exception to the impact rule requires a host action in the form of a tort directed to or committed against the claimant is unsupported by case precedent.³² While the Second District Court of Appeals is attempting to insert the impact requirement into the law of intentional infliction of emotional distress,³³ the Third District Court of Appeals appears ready to abolish the impact requirement as a condition to recovery for negligently inflicted emotional distress.³⁴ The Indiana Supreme Court's refusal to grant the petition for transfer and clarify the law,³⁵ along with the willingness of several Indiana higher court judges to abolish the impact rule in both the intentional and negligent infliction of emotional distress areas,³⁶ coupled with the lack of precedential value of the court of appeal's decision in *Elza*, leave the Indiana law with respect to recovery for emotional distress a tangled web. The harbinger of Justice Hunter's dissent in *Elza* declares, "[t]his Court should seize this opportunity to overrule *Boden* and eliminate confusion such as that which its language has here conceived."³⁷ It can only be hoped that the Indiana Supreme Court will seize the next opportunity to untangle the web.

II. INTENTIONAL VERSUS NEGLIGENT INFLICTION

A. *The Dichotomy between Requirements for Recovery*

The courts have imposed far more substantial barriers to recovery for negligently inflicted emotional distress than they have in cases involving intentionally inflicted emotional distress.

³⁰*Troue v. Marker*, 253 Ind. 284, 295, 252 N.E.2d 800, 806 (1969).

³¹*Id.* at 289-90, 252 N.E.2d at 803-04.

³²Although the host torts at issue in *Montgomery v. Crum*, 199 Ind. 660, 161 N.E. 251 (1928), *Felkner v. Scarlet*, 29 Ind. 154 (1867), *Pruitt v. Cox*, 21 Ind. 15 (1863), and *Aetna Life Ins. Co. v. Burton*, 104 Ind. App. 576, 12 N.E.2d 360 (1938) were not directed at the person claiming mental distress, recovery was allowed.

³³*See* No. 2-1180-A-371.

³⁴*See Kroger Co. v. Beck*, 375 N.E.2d 640, 645 n.5 (Ind. Ct. App. 1978).

³⁵426 N.E.2d 1302 (Ind. 1981).

³⁶*See id.* at 1303-04, 1308, 1312 (Hunter, J., dissenting); No. 2-1180-A-371, slip op. at 6 (Sullivan, J., concurring); 375 N.E.2d at 645 n.5.

³⁷426 N.E.2d at 1312 (Hunter, J., dissenting).

Although there are persuasive arguments for different results in these two types of cases, the barriers erected by the courts seldom advance these arguments and do no more than draw arbitrary lines which produce incongruous and indefensible results. The courts and commentators have neglected to challenge these incongruities and suggest reconciliation where appropriate. The following will expose these differences in approach, analyze and evaluate them, and suggest a principled synthesis.

B. *The Dichotomy First Appears*

The first case to establish different prerequisites to recovery for negligently inflicted emotional distress and intentionally inflicted emotional distress was the English case of *Wilkinson v. Downtown*.³⁸ In *Wilkinson*, the defendant told the plaintiff that the plaintiff's husband had been seriously injured in an accident and that the plaintiff was to go at once to see him. The defendant knew these statements to be false and meant for the plaintiff to believe them. The plaintiff did believe them with the result that she became seriously ill from a shock to her nervous system. Allowing recovery, Judge Wright held that the Privy Council's decision in *Victorian Railways Commissioners v. Coultas*,³⁹ generally recognized as inspiring the impact rule in the United States⁴⁰ and explicitly considered in Indiana's initial adoption of the impact rule,⁴¹ was not precedential authority because there was no element of intentional wrong in that case.⁴²

The first case of this kind in the United States was *Hickey v. Welch*⁴³ which distinguished between the negligent and the intentional infliction of emotional distress without citing specific precedents or giving cogent reasons for such a distinction. Discussing cases which denied relief for injuries following fright, the Missouri Court of Appeals in *Hickey* stated:

But nearly all the cases in which the rule was applied that no recovery is permissible for mental anguish, fright or their *sequelae*, were where the tort alleged was negligence. The decisions usually state that if the act was willful, malicious or accompanied by circumstances of inhumanity

³⁸[1897] 2 Q.B. 57.

³⁹[1888] 13 App. Cas. 222.

⁴⁰46 MISS. L.J. 871, 872 (1975); Note, *Mental Distress—The Impact Rule*, 42 UMKC L. REV. 234, 234 (1973).

⁴¹*Kalen v. Terre Haute & I.R.R.*, 18 Ind. App. 202, 208-10, 47 N.E. 694, 696-97 (1897).

⁴²*Wilkinson v. Downtown*, [1897] 2 Q.B. 57, 59-60.

⁴³91 Mo. App. 4 (1901).

and oppression, an action lies for mental anguish, whether physical harm was done or not. A precedent exactly deciding this proposition is not at hand; but it is assumed to be the law in the text-books and in most of the cases which exonerate the defendant where negligence is the basis of the action.⁴⁴

With this crude beginning of citation to assumed authority and decision without articulation of supporting reasons, the stage was set for a dichotomy in emotional distress law which persists to this day.⁴⁵

C. Lines Drawn Because of Moral Culpability

The first Indiana case to distinguish between the negligent and the intentional infliction of emotional distress was *Kline v. Kline*.⁴⁶ In *Kline*, the Indiana Supreme Court held that while current authority provided no recovery for emotional distress in negligence actions in which there has been no physical impact, this is not the law as applied to the commission of a willful and intentional wrong.⁴⁷ Unlike the Missouri court in *Hickey*, the Indiana Supreme Court's reasoning is apparent from its quotation of the Massachusetts Supreme Court's opinion in *Spade v. Lynn & B.R.R.*:⁴⁸ "The logical vindication of this rule is that it is unreasonable to hold persons, who are merely negligent, bound to anticipate and guard against fright and the consequences of fright; and that this would open a wide door for unjust claims that could not be successfully met."⁴⁹ The Massachusetts and Indiana Supreme Courts were expressing a fear of fraudulent emotional distress claims, implicitly saying that negligent conduct is not sufficiently reprehensible to cause the courts to abandon this fear of fraudulent claims in favor of allowing recovery. This reasoning is an extension of the natural tendency of courts to expand liability as the moral guilt of the defendant increases.⁵⁰

This tendency to pay attention to the degree of the defendant's fault, even independent of the theory of exemplary damages, dates back to the ancient Roman courts.⁵¹ The idea of liability based upon

⁴⁴*Id.* at 13.

⁴⁵See Prosser, *Intentional Infliction of Mental Suffering: A New Tort*, 37 MICH. L. REV. 874, 878 (1939) (hereinafter cited as Prosser Article).

⁴⁶158 Ind. 602, 64 N.E. 9 (1902).

⁴⁷*Id.* at 605, 64 N.E. at 10.

⁴⁸168 Mass. 285, 47 N.E. 88 (1897).

⁴⁹158 Ind. at 606, 64 N.E. at 10 (quoting *Spade v. Lynn & B.R.R.*, 168 Mass. 285, 290, 47 N.E. 88, 89 (1897)).

⁵⁰See Prosser Article, *supra* note 45, at 878.

⁵¹See W. BUCKLAND, A TEXT-BOOK OF ROMAN LAW 587 (3d. ed. 1963), in which the author states:

Where a man wounded another not mortally, who died in consequence of

fault arose from the partly philosophical, partly religious, partly ethical texture of intellectual tenets characterizing man's conduct as either good or bad and mandating that all society be ordered accordingly.⁵² This deep-rooted intolerance of intentional misconduct is shown by Justice Holmes' statement at the turn of the century. "It has been considered that, *prima facie*, the intentional infliction of temporal damage is a cause of action, which, as a matter of substantive law, whatever may be the form of pleading, requires a justification if the defendant is to escape."⁵³

By imposing an impact requirement in negligent infliction cases, the Indiana court in *Kline* was attempting to set a standard of liability roughly congruent with the degree of the defendant's moral culpability. By tempering the rules of causation and certainty of proof to fit the kinds and degrees of moral fault, the courts have made justice fit the kind and degree of fault in the particular case.⁵⁴

Although, in its purest form, the rationale of extending liability as the moral guilt of the defendant increases is meritorious, the Massachusetts and Indiana Supreme Courts, as well as many other proponents, attempt to extend this rationale beyond its logical conclusion in reasoning that intentional misconduct provides assurance that mental distress actually occurred. For example, William Prosser, noting this tendency of courts to allow recovery commensurate with the defendant's degree of fault, wrote:

But perhaps more important is the fact that in such intentional misconduct there is an element of outrage, which in itself is an important guarantee that the mental disturbance which follows is serious, and that it is not feigned. Not only is there a normal social desire to compensate the victim at the expense of the more heinous offender whose conduct is subject to every moral condemnation, but the danger of imposition is lessened to a point where it becomes reasonably safe to grant the remedy.⁵⁵

being neglected, he was liable for the wounding but not for the death. But if the original act was wilful it is generally held (there is no clear text) that intervening negligence of the injured person was no defence, though there was the same breach of causal *nexus*.

Id. (footnote omitted).

⁵²Green, *The Duty Problem in Negligence Cases* (pt.2), 29 COLUM. L. REV. 255, 255 (1929).

⁵³*Aikens v. Wisconsin*, 195 U.S. 194, 204 (1904).

⁵⁴Bauer, *The Degree of Moral Fault as Affecting Defendant's Liability*, 81 U. PA. L. REV. 586, 596 (1933) (hereinafter cited as Bauer).

⁵⁵Prosser Article, *supra* note 45, at 878. The Indiana Supreme Court in *Kline* also advanced this reason when it adopted the rationale that allowing recovery for negligent infliction of emotional distress "would open a wide door for unjust claims that could not be successfully met." 158 Ind. at 606, 64 N.E. at 10.

There are several flaws in the reasoning underlying this belief that, absent intentional misconduct, assurance that emotional distress actually occurred is lacking. First, William Prosser himself has contended that the problem of feigning injuries can be solved simply by testing the adequacy of the proof of emotional injury in each case and denying recovery when proof of the genuineness of the injury is inadequate.⁵⁶ Second, today's state of medical science makes accurate proof of emotional distress possible.⁵⁷ Moreover, although the fear of fraudulent claims is well-founded, intentional misconduct does nothing to separate the legitimate from the illegitimate claims; intentional misconduct does not ensure that the emotional distress claimed is genuine, nor does the absence of intentional misconduct and the presence of only negligence ensure that the claim is fraudulent.⁵⁸

Extending liability as the moral culpability of the defendant increases is a principle of law rooted in history and morality. However, statements made by courts and commentators that intentional misconduct guarantees the genuineness of emotional distress claims are overextended. The fear of fraudulent emotional distress claims is a legitimate fear against which there must be protection, but intentional misconduct offers little, if any, protection. Only requirements that, in fact, effectively test the genuineness of emotional distress claims are defensible.

D. Arbitrary Tests Imposed

The courts have erected artificial barriers to recovery for negligently inflicted emotional distress⁵⁹ by deciding whether recovery will be allowed based primarily upon the "impact rule," the "zone of danger rule,"⁶⁰ or the "foreseeability test."⁶¹ Yet, these same courts decide whether recovery for intentionally inflicted emotional distress will be allowed based simply upon the likelihood and

⁵⁶W. PROSSER, *supra* note 7, at 328.

⁵⁷*Leong v. Takasaki*, 55 Hawaii 398, 411-13, 520 P.2d 758, 766-67 (1975); *Knierim v. Izzo*, 22 Ill. 2d 73, 85, 174 N.E.2d 157, 164 (1961); Comment, *Negligently Inflicted Mental Distress: The Case for an Independent Tort*, 59 GEO. L.J. 1237, 1258-63 (1971).

⁵⁸See *Rickey v. Chicago Transit Auth.*, 427 N.E.2d 596, 598 (Ill. Ct. App. 1981).

⁵⁹See *Negligent Infliction Note*, *supra* note 7, at 467-74.

⁶⁰The "zone of danger rule" provides that, as a minimum prerequisite to recovery, plaintiff must have been within the range of ordinary physical peril. *Resavage v. Davies*, 199 Md. App. 479, 487, 86 A.2d 879, 883 (1952); *Tobin v. Grossman*, 24 N.Y.2d 609, 616, 249 N.E.2d 419, 423, 301 N.Y.S.2d 554, 559 (1969); *Waube v. Warrington*, 216 Wis. 603, 612-13, 258 N.W. 497, 500-01 (1935).

⁶¹The "foreseeability test," also labelled the "zone of emotional danger rule," predicates recovery upon whether defendant should have foreseen fright or shock severe enough to cause substantial injury in a person normally constituted. *Dillon v. Legg*, 68 Cal. 2d 728, 740, 441 P.2d 912, 920, 69 Cal. Rptr. 72, 80 (1968).

presence of mental distress.⁶² Although the reasons articulated by the courts for imposing such requirements in negligent infliction cases include fear of fraudulent claims,⁶³ fear that the courts will be drowned in a flood of emotional distress litigation,⁶⁴ fear that emotional distress damages are not susceptible of accurate measurement,⁶⁵ and a felt need to limit liability,⁶⁶ the imposition of these requirements does not logically address those reasons.⁶⁷ Furthermore, allowing recovery for emotional distress in intentional infliction cases is inconsistent with three of these four reasons because intentional misconduct does little to guarantee that the claim is meritorious, that the damages will be susceptible of accurate measurement, or that the courts will be free from a litigation deluge.

Although allowing recovery only in intentional infliction cases might reduce the number of mental distress cases, such an artificial distinction does not ascertain the legitimacy of the claim and leaves the court with the same problems in testing the claim. Thus, barriers to recovery resulting from the impact rule, the zone of danger rule, and the foreseeability test, which the courts have erected in negligent infliction of emotional distress cases, fail to meet the fears and concerns for which they were imposed.⁶⁸ It has been suggested that the construction of these obstacles to recovery by the courts can be characterized as a further crude attempt to make justice roughly fit the kind and degree of moral fault in each particular case.⁶⁹

E. Resultant Physical Injury Requirement Imposed

A further barrier which, although practically nonexistent in intentional infliction cases, stands as a virtually universal barrier to recovery in negligent infliction cases is the requirement of resultant

⁶²Handford, *Intentional Infliction of Mental Distress: Analysis of the Growth of a Tort*, 8 ANGLO-AM. L. REV. 1, 14-18 (1979) (hereinafter cited as Handford).

⁶³See *Cleveland, C., C. & St. L. Ry. v. Stewart*, 24 Ind. App. 374, 382-86, 56 N.E. 917, 920-21 (1900); *Mitchell v. Rochester Ry.*, 151 N.Y. 107, 110, 45 N.E. 354, 354-55 (1896); *Waube v. Warrington*, 216 Wis. 603, 613, 258 N.W. 497, 501 (1935).

⁶⁴See *Kalen v. Terre Haute & I.R.R.*, 18 Ind. App. 202, 213, 47 N.E. 694, 698 (1897); *Spade v. Lynn & B.R.R.*, 168 Mass. 285, 290, 47 N.E. 88, 89 (1897).

⁶⁵See *Western Union Tel. Co. v. Ferguson*, 157 Ind. 64, 66, 60 N.E. 674, 675 (1901); *Mitchell v. Rochester Ry.*, 151 N.Y. 107, 110, 45 N.E. 354, 354-55 (1896).

⁶⁶*Dillon v. Legg*, 68 Cal. 2d 728, 739, 741-46, 441 P.2d 912, 919, 921-24, 69 Cal. Rptr. 72, 79, 81-84 (1968); *Spade v. Lynn & B.R.R.*, 168 Mass. 285, 288-89, 47 N.E. 88, 89 (1897); *Waube v. Warrington*, 216 Wis. 603, 613, 258 N.W. 497, 501 (1935).

⁶⁷See *Negligent Infliction Note*, *supra* note 7, at 468-74.

⁶⁸See *id.* See also notes 63 & 64 *supra*.

⁶⁹See *Bauer*, *supra* note 54, at 589-96.

physical injury. The most enlightening comparison of the torts of intentional and negligent infliction of emotional distress is available in this requirement. Although a majority of the nation's jurisdictions impose no prerequisite of resulting physical injuries to the plaintiff for actionable intentionally inflicted emotional distress,⁷⁰ the traditional rule in tort law is that the negligent infliction of emotional distress is not compensable unless such infliction results in physical injury to the plaintiff or objective manifestations thereof.⁷¹ A review of the history of this dichotomy is necessary to an understanding of the reasons for its development and an evaluation of its justification.

In the early emotional distress cases the courts required a showing of physical injuries to the plaintiff in intentional as well as negligent infliction of emotional distress cases.⁷² However, the courts began carving out exceptions to this resultant physical injury requirement, gradually eroding this rule in intentional infliction cases until the requirement became virtually nonexistent in the intentional infliction area.

This split in requirements began when the Iowa Supreme Court, in the intentional infliction case of *Watson v. Dilts*⁷³ although imposing a resulting physical injury requirement, abrogated the impact requirement and allowed recovery, parasitic to an independent intentional host tort, for physical disability produced by fright unaccompanied by physical impact. Noting that the weight of authority was to the contrary, the court in *Watson* stated the intentional misconduct "might well cause alarm to the boldest man, and, if it produced nervous prostration and physical disability, the theory, no matter what its reason, that would say there was not actionable wrong, would be too fine spun and too cold for our sanction."⁷⁴ However, the court noted that a different result would have followed had the defendant's conduct been merely negligent.⁷⁵ The court's finding in *Watson* that the defendant's conduct was so outrageous and extremely likely to cause severe emotional distress that any reasons militating against recovery were overcome qualifies *Watson* as yet another case imposing different prerequisites to recovery for intentionally and negligently inflicted emotional distress because of differences in moral culpability. In *Voss v. Bolzenius*,⁷⁶ the court held that the result-

⁷⁰See Handford, *supra* note 62, at 19.

⁷¹See *id.* at 21; Leong v. Takasaki, 55 Hawaii 398, 400, 520 P.2d 758, 761 (1974).

⁷²See Wilkinson v. Downtown, [1897] 2 Q.B. 57, 58-59; Hickey v. Welch, 91 Mo. App. 4, 9 (1901).

⁷³116 Iowa 249, 89 N.W. 1068 (1902).

⁷⁴*Id.* at 250, 89 N.W. at 1069.

⁷⁵*Id.* at 250-51, 89 N.W. at 1069-70.

⁷⁶147 Mo. App. 375, 128 S.W. 1 (1910).

ant physical injury requirement imposed in *Watson* was satisfied by loss of sleep, perhaps showing that the physical consequence requirement had become a strain in intentional infliction cases.

As the courts began to wonder why physical injury was so important and the existing knowledge about the effects of emotion on the body was enlarged by continuing research, they prepared to relax the resultant physical injury restriction in intentional infliction cases. The next step in the evolutionary process was taken when the courts began to allow recovery for intentionally inflicted emotional distress, unaccompanied by resulting physical injury parasitic to independent intentional host torts.⁷⁷ The Iowa Supreme Court, again taking the lead, stated in *Barnett v. Collection Service Co.*:⁷⁸

The rule seems to be well-established where the act is willful or malicious, as distinguished from being merely negligent, that recovery may be had for mental pain, though no physical injury results. In such a case the door to recovery should be opened but narrowly and with due caution.⁷⁹

From the above historical analysis, the reasons for development of the split between requiring resultant physical injuries in negligent infliction cases and not requiring such injuries in intentional infliction cases become apparent. The fears of feigned injuries, unlimited liability, and an opening of the floodgates of litigation paled in light of the outrageous conduct and its consequences in the most severe cases. As the intentional infliction of emotional distress became recognized as an independent tort, it became less justifiable to allow the cause of action to remain attached to a physical harm because the new tort, by its nature, involved an intentional act causing severe mental distress. The perception that the imposition of liability upon tortfeasors who were merely negligent would be burdensome and disproportionate in relation to their culpability left the courts without a similar inclination to abandon their fears of fraudulent claims, unlimited liability, and a flood of litigation in the negligent infliction area.⁸⁰

Although extending liability to fit the degree of moral fault is legitimate, allowing recovery where a claimant can show a physical injury has nothing to do with moral culpability. To the extent that courts' fears of fraudulent claims, unlimited liability, and a flood of litigation are overcome by the heinous conduct of the tortfeasor in

⁷⁷See *Wilson v. Wilkins*, 181 Ark. 137, 25 S.W.2d 428 (1930); *Lyons v. Smith*, 176 Ark. 728, 3 S.W.2d 982 (1928); *Kurpgewelt v. Kirby*, 88 Neb. 72, 129 N.W. 177 (1910).

⁷⁸214 Iowa 1303, 242 N.W. 25 (1932).

⁷⁹*Id.* at 1310, 242 N.W. at 28.

⁸⁰See, e.g., *Butchikas v. Travelers Indemn. Co.*, 343 So. 2d 816 (Fla. 1977).

intentional infliction cases but are reflected by the physical injury requirement in negligent infliction cases, the courts are imposing irrational barriers to recovery which simply chop off liability at an arbitrary point. There is no compelling reason to limit liability at the point of physical manifestations of emotional distress.

The fear that a finding of emotional distress, absent resulting physical injury, is subject to mere speculation and conjecture can be no less in intentional infliction cases than in negligent infliction cases. Advancements in medical and psychiatric science throughout this century have discredited the belief that medical science is unable to establish a causal link between psychic injuries and alleged misconduct.⁸¹ Because other safeguards⁸² exist to test the authenticity of a claim for relief, the requirement of resulting physical injury, like the requirement of a contemporaneous physical impact, should not stand as an artificial barrier to recovery.⁸³

One court has characterized the resulting physical injury requirement as "another synthetic device to guarantee the genuineness of the claim."⁸⁴ Another has stated that "to continue to require physical injury caused by culpable tortious conduct, when mental suffering may be equally recognizable standing alone, would be an adherence to procrustean principles which have little or no resemblance to medical realities."⁸⁵ Alabama, Hawaii, and Pennsylvania are the only jurisdictions which have abrogated the resultant physical injury prerequisite to recovery for negligently inflicted emotional distress.⁸⁶

F. *The Evolution Continues*

The law regarding negligent infliction of emotional distress is evolving, albeit more slowly than did the law in the intentional infliction area. While a majority of the nation's jurisdictions followed

⁸¹See *Sinn v. Burd*, 486 Pa. 146, 158-59, 404 A.2d 672, 678-79 (1979). The court quoted one commentator who discussed the advances in scientific proof of mental distress: "The development of psychiatric tests and the refinement of diagnostic techniques has led some authorities to conclude that science can establish with reasonable medical certainty the existence and severity of psychic harm." *Id.* (quoting 63 GEO. L.J. 1179, 1184-85). See also Liebson, *Recovery of Damages for Emotional Distress Caused by Physical Injury to Another*, 15 J. FAM. L. 163 (1976-77).

⁸²Other safeguards include medical and psychiatric evidence, as well as applications by the triers of fact of standards of reasonableness, common sense, and experience.

⁸³*Leong v. Takasaki*, 55 Hawaii 398, 403, 520 P.2d 758, 762 (1974).

⁸⁴486 Pa. at 160, 404 A.2d at 679.

⁸⁵*Taylor v. Baptist Medical Center, Inc.*, 400 So. 2d 369, 374 (Ala. 1981).

⁸⁶See *id.*

the impact rule at the turn of the century,⁸⁷ the impact requirement has now been discredited and only a handful of jurisdictions follow it today.⁸⁸ A loosening of the resultant physical injury requirement is also occurring. Much as in the last stages of the evolutionary process which concluded with the courts finally disposing of the resulting physical injury requirement in intentional infliction cases, some courts are now straining to find the resultant physical injuries prerequisite to recovery in negligent infliction cases. A Michigan court has found that a plaintiff who, as the result of seeing her daughter negligently killed, withdrew from normal forms of socialization, became temporarily unable to perform as before, and continued in a state of depression, had suffered a physical injury sufficient to allow recovery.⁸⁹ Reaching the pinnacle, the Supreme Court of Hawaii has explicitly recognized the negligent infliction of emotional distress as an independent tort without any requirement of physical injury.⁹⁰

III. RECOMMENDATION: RATIONALIZATION AND RECONCILIATION

Requiring intentional misconduct, resultant physical injuries, contemporaneous physical impact, placement in the zone of danger, or foreseeability of emotional distress injuries does not guarantee that emotional distress has occurred. The courts fail to recognize that emotional distress, whether inflicted intentionally or negligently, is the same emotional distress and does not become more real simply because it was intentionally inflicted. Either the reasons articulated for the differences between the court-imposed prerequisites to recovery for negligently inflicted emotional distress and intentionally inflicted emotional distress are unpersuasive⁹¹ or the requirements imposed are unrelated to the valid reasons for differences.⁹² There are only two rational alternatives regarding tort liability for the infliction of emotional distress, whether intentional or negligent: denial of recovery because the plaintiff's interests in being free from subjection to emotional distress are not legally protected, or

⁸⁷*Rickey v. Chicago Transit Auth.* 428 N.E.2d 596, 598 (Ill. Ct. App. 1981).

⁸⁸*See, e.g., Elza v. Liberty Loan Corp.*, 426 N.E.2d 1302 (Ind. 1981) (Hunter, J., dissenting).

⁸⁹*Toms v. McConnell*, 45 Mich. App. 647, 657, 207 N.W.2d 140, 145 (1973). The Michigan Supreme Court allowed a finding of the requisite physical injury from plaintiff's sudden loss of weight, inability to perform ordinary household duties, extreme nervousness, and irritability. *Daley v. LaCroix*, 384 Mich. 4, 12-13, 179 N.W.2d 390, 395 (1970).

⁹⁰*See Kelley v. Kokua Sales & Supply, Ltd.*, 56 Hawaii 204, 208, 532 P.2d 673, 675 (1975); *Leong v. Takasaki*, 55 Hawaii 398, 407-08, 520 P.2d 758, 764-65 (1974).

⁹¹*See* notes 56-58 *supra* and accompanying text.

⁹²*See* notes 56-58, 63-68 & 81-85 *supra* and accompanying text.

allowance of recovery when the plaintiff can show breach of duty and causation.

Nevertheless, the courts and commentators continue to treat intentionally inflicted emotional distress radically different from negligently inflicted emotional distress. Although the *Restatement (Second) of Torts* has established intentional infliction of emotional distress as an independent tort,⁹³ and although most jurisdictions in the United States recognize the tort of intentional infliction of emotional distress,⁹⁴ virtually all the courts have refused to recognize

⁹³RESTATEMENT (SECOND) OF TORTS § 46 (1965) provides:

- (1) One who by extreme and outrageous conduct intentionally or recklessly causes severe emotional distress to another is subject to liability for such emotional distress, and if bodily harm to the other results from it, for such bodily harm.
- (2) Where such conduct is directed at a third person, the actor is subject to liability if he intentionally or recklessly causes severe emotional distress
 - (a) to a member of such person's immediate family who is present at the time, whether or not such distress results in bodily harm, or
 - (b) to any other person who is present at the time, if such distress results in bodily harm.

Id.

⁹⁴Handford, *supra* note 62, at 1. At least thirty-eight jurisdictions recognize the intentional infliction of emotional distress as an independent tort. See *American Road Serv. Co. v. Inmon*, 394 So. 2d 361 (Ala. 1980); *Watts v. Golden Age Nursing Home*, 127 Ariz. 255, 619 P.2d 1032 (1980); *Counce v. M.B.M. Co.*, 266 Ark. 1064, 597 S.W.2d 92 (1979); *State Rubbish Collectors Ass'n v. Silizhoff*, 38 Cal. 2d 330, 240 P.2d 282 (1952); *Rugg v. McCarty*, 173 Colo. 170, 476 P.2d 753 (1970); *Urban v. Hartford Gas Co.*, 139 Conn. 301, 93 A.2d 292 (1952); *Waldon v. Covington*, 415 A.2d 1070 (D.C. 1980); *Ford Motor Credit Co. v. Sheehan*, 373 So. 2d 956 (Fla. Ct. App. 1979); *Whitmire v. Woodbury*, 154 Ga. App. 159, 267 S.E.2d 783 (1980), *rev'd on other grounds*, 246 Ga. 349, 271 S.E.2d 491 (1980); *Fraser v. Morrison*, 39 Hawaii 370 (1952); *Hatfield v. Max Rouse & Sons Northwest*, 100 Idaho 840, 606 P.2d 944 (1980); *Public Fin. Corp. v. Davis*, 66 Ill. 2d 85, 360 N.E.2d 765 (1976); *Meyer v. Nottger*, 241 N.W.2d 911 (Iowa 1976); *Wiehe v. Kukal*, 225 Kan. 478, 592 P.2d 860 (1979); *Steadman v. South Cent. Bell Tel. Co.*, 362 So. 2d 1144 (La. Ct. App. 1978); *Vicnire v. Ford Motor Credit Co.*, 401 A.2d 148 (Me. 1979); *Richey v. American Auto Ass'n, Inc.*, 406 N.E.2d 675 (Mass. 1980); *Fry v. Ionia Sentenial—Standard*, 101 Mich. App. 725, 300 N.W.2d 687 (1980); *LaBrier v. Anheuser Ford, Inc.*, 612 S.W.2d 790 (Mo. Ct. App. 1981); *Paasch v. Brown*, 193 Neb. 368, 227 N.W.2d 402 (1975); *Star v. Rabello*, 625 P.2d 90 (Nev. 1981); *Hume v. Bayer*, 157 N.J. Super. 310, 428 A.2d 966 (1981); *Fischer v. Maloney*, 43 N.Y.2d 553, 373 N.E.2d 1215 (1978); *Dickens v. Puryear*, 276 S.E.2d 325 (N.C. 1981); *Breeden v. League Servs. Corp.*, 575 P.2d 1374 (Okla. 1978); *Turman v. Central Billing Bureau, Inc.*, 279 Or. 443, 568 P.2d 1382 (1977); *Mullen v. Suchko*, 279 Pa. Super. 499, 421 A.2d 310 (1980); *Ford v. Hutson*, 276 S.E.2d 776 (S.C. 1981); *First Nat. Bank v. Bragdon*, 84 S.D. 89, 167 N.W.2d 381 (1969); *Moorhead v. J.C. Penney Co.*, 555 S.W.2d 713 (Tenn. 1977); *Samms v. Eccles*, 11 Utah 2d 289, 358 P.2d 344 (1961); *Sheltra v. Smith*, 136 Vt. 472, 392 A.2d 431 (1978); *Womack v. Eldridge*, 215 Va. 338, 210 S.E.2d 145 (1974); *Phillips v. Hardwick*, 29 Wash. App. 382, 628 P.2d 506 (1981); *Harless v. First Nat. Bank*, 246 S.E.2d 270 (W. Va. 1978); *Scarpaci v. Milwaukee County*, 96 Wis. 2d 663, 292 N.W.2d 816 (1980).

the negligent infliction of emotional distress as an invasion of an interest sufficient to constitute a tort.⁹⁵

The means to right this inconsistency and irrationality in the law lies in the wisdom of a statement made by the Massachusetts Supreme Court in abolishing the impact rule: "[e]very effort must be made to avoid arbitrary lines which 'unnecessarily produce incongruous and indefensible results.' . . . The focus should be on underlying principles."⁹⁶ The only rational way to avoid arbitrary lines and artificial barriers is to weigh all those considerations of policy which favor a plaintiff's recovery against those favoring a limitation on a defendant's liability and determine in each particular case whether the balance tips the scale against or in favor of recovery. As early as 1915, Dean Pound recognized that the needed distinction between recovery for negligent infliction and recovery for intentional infliction of emotional distress should come from a balancing of the differing social interests.

In cases of negligence the individual interest of the actor,—that is, his interest in the free exercise of his faculties,—must be weighed as well as the social interest against imposture and the practical difficulties of proof and reparation. Where he exercises his faculties for purposes recognized by law and, so far as he could reasonably foresee, does nothing that would work an injury, the individual interest of the unduly sensitive or abnormally nervous must give way. But the law does not secure individuals in the free exercise of their faculties for the purpose of injuring others, since obvious social interests are opposed to such a claim. Hence, if there was an intention to injure, only the social interest against imposture and the practical difficulties are to be weighed. This is the philosophical basis of the distinction made in these cases. Probably advance in our knowledge of psychology and mental pathology and progress in means of arriving at the truth in matters where expert evidence is required will determine the development of the law upon this subject.⁹⁷

⁹⁵See *Leong v. Takasaki*, 55 Hawaii 398, 402-03, 520 P.2d 758, 761-62 (1974); Comment, *supra* note 57, at 1237.

⁹⁶*Dziokonski v. Babineau*, 375 Mass. 555, 568, 380 N.E.2d 1295, 1302 (1978) (quoting *Mone v. Greyhound Lines, Inc.*, 368 Mass. 354, 365, 331 N.E.2d 916, 922 (1975) (Braucher, J., dissenting)).

⁹⁷Pound, *Interests of Personality*, 28 HARV. L. REV. 343, 361-62 (1915). The advance in our knowledge of psychology and mental pathology and the ability to achieve a degree of certainty in these areas which Dean Pound foresaw are at hand. See notes 57 & 81 *supra* and accompanying text.

The result of this process of weighing the interests involved and apportioning the risks according to the dictates of justice has been characterized in tort law vernacular as "duty."⁹⁸ This approach is useful and necessary in both the intentional and negligent infliction of emotional distress areas. Although the results may differ between these areas, the differences will be explainable by the differing balances resulting from weighing the policy considerations militating for and against recovery rather than by the imposition of artificial barriers which have little, if any, relation to the reasons for the differences.

The premier policy consideration in the emotional distress area is to what extent recovery for the infliction of emotional distress should be allowed. Surely this concern is now troubling the Indiana courts as some of them attempt to draw tight the reins of recovery for both negligently and intentionally inflicted emotional distress around the narrow impact rule.⁹⁹ In answering the questions raised by this concern, many factors must be considered. The proviso of the Indiana Constitution that every person shall have remedy for injury done to him¹⁰⁰ is not without limitation.

Although nearly all jurisdictions recognize that the interest in freedom from severe emotional distress is regarded as of sufficient importance to require others to refrain from conduct intended to invade it,¹⁰¹ recognition of a blanket right to freedom from severe emotional distress has been seriously questioned.¹⁰² It has been suggested that even though the law may protect emotional tranquility over a great range of interests, it should not safeguard emotional tranquility as to all interests.¹⁰³ William Prosser eloquently argues:

Liability still cannot be extended to every trifling indignity. The rough edges of our society still are in need of a great deal of filing down, and the plaintiff in the meantime must necessarily be expected and required to be hardened to a certain amount of rough language, and to occasional acts that are definitely inconsiderate and unkind. There is no occasion for the law to intervene with balm for wounded

⁹⁸See, e.g., *Leong v. Takasaki*, 55 Hawaii 398, 407, 520 P.2d 758, 764 (1974); W. PROSSER, *supra* note 7, at 325-26.

⁹⁹See note 12 *supra* and accompanying text.

¹⁰⁰IND. CONST. art. 1, § 12.

¹⁰¹See, e.g., *State Rubbish Collectors Ass'n v. Siliznoff*, 38 Cal. 2d 330, 337, 240 P.2d 282, 285 (1952) (quoting RESTATEMENT OF TORTS § 46, comment d at 72-73 (Supp. 1948)).

¹⁰²Theis, *The Intentional Infliction of Emotional Distress: A Need for Limits on Liability*, 27 DEPAUL L. REV. 275, 277 (1977).

¹⁰³*Id.* at 278.

feelings in every case where a flood of billingsgate is loosed in an argument over a back fence. There is still, in this nation at least, such a thing as freedom to express an unflattering opinion; and some safety valve must be left through which irascible tempers may blow off relatively harmless steam.

There is an obvious difference between the threat of a group of self-appointed vigilantes to string the plaintiff up to a sour apple tree, and the mere statement to his face that they think that he is the meanest man in town. There is a difference between an infuriated railroad conductor raucously bellowing opprobrious epithets at humiliated passengers, and the mild discourtesy of "Hurry up! Do you think we've got all night?" . . . It is all a matter of drawing the line.¹⁰⁴

It has been argued that it is the place of society, and not the province of the law, to breed a certain toughening of the mental hide.¹⁰⁵ Minor emotional shocks are inevitable consequences of everyday living and social controls may provide a more effective means for dealing with the infliction of these small degrees of emotional distress than do legal controls.¹⁰⁶

The reason underlying this discussion by the courts and commentators is the fear of unlimited liability.¹⁰⁷ There are two rational responses to this fear. One response is that emotional distress, however inflicted, is not the type of injury for which the law will offer redress. Should the Indiana courts reach this decision after a consideration of all the policy considerations involved, such a position would be more defensible than the present state of Indiana law of imposing the arbitrary impact rule in both negligent and intentional infliction cases. At least the Indiana courts will have reached their decision by evaluating competing considerations and choosing the result which reflects the way the balance of considerations tips.

However, such a position would run counter to virtually all this

¹⁰⁴Prosser Article, *supra* note 45, at 887 (citations omitted).

¹⁰⁵Smith, *Relation of Emotions to Injury and Disease: Legal Liability for Psychic Stimuli*, 30 VA. L. REV. 193, 229 n.128 (1944) in which the author writes that "[p]sychic stimuli multiply as society becomes more complex and people are crowded together, but this is part and parcel of existence. Our concern should be with conditioning the citizen, and with breeding more toughness by pampering the psyche less." See also McGruder, *Mental and Emotional Disturbance in the Law of Torts*, 49 HARV. L. REV. 1033, 1035 (1936), in which the author writes that "[a]gainst a large part of the frictions and irritations and clashing of temperaments incident to participation in a community life, a certain toughening of the mental hide is better protection than the law could ever be."

¹⁰⁶Rodrigues v. State, 52 Hawaii 156, 172-73, 472 P.2d 509, 520 (1970).

¹⁰⁷See Prosser Article, *supra* note 45, at 887.

nation's jurisdictions which recognize that a line can and must be drawn between the slight hurts, which are the price of a complex society, and the severe mental disturbances inflicted by intentional actions wholly lacking in social utility.¹⁰⁸ In making such a decision Indiana would be, as Prosser has stated, "fighting a rear-guard action."¹⁰⁹

The second reasonable response to this fear of boundless liability is to limit recovery to claims of "serious mental distress."¹¹⁰ The use of a test which focuses upon the situation causing the emotional distress and requires it to be of a nature that would be likely to produce a response in a person of average sensibilities would satisfy this need to adopt general standards that test the seriousness of mental distress in any particular case. This would impose a prerequisite to recovery which is rationally related to a legitimate judicial fear of limitless liability.¹¹¹

Adherence to the duty approach requires that courts view the policy considerations from the defendant's standpoint as well by looking at "not merely what it might be right for an injured person to receive [in order] to afford just compensation for his injury, but also what it is just to compel the other party to pay."¹¹² The duty analysis recognizes that "one cannot always look to others to make compensation for injuries received"¹¹³ because a balancing of policy considerations requires that the sufferer bear the consequences of many accidents alone.¹¹⁴

The courts have shown more willingness to impose liability for the infliction of mental distress when they perceive that the evil done by the defendant is far greater than any evil which allowing recovery could cause, as opposed to situations in which the defendant's conduct was merely "simple negligence."¹¹⁵ This consideration presents a persuasive reason for distinguishing between recovery for negligent infliction of emotional distress and recovery for intentional infliction of emotional distress, because the court may determine that the competing social and economic considerations make it unreasonable to bind persons who are merely negligent to anticipate and guard against fright and its consequences.¹¹⁶ This reasoning

¹⁰⁸See *Knierim v. Izzo*, 22 Ill. 2d 73, 85, 174 N.E.2d 157, 164 (1961).

¹⁰⁹W. PROSSER, *supra* note 7, at 333.

¹¹⁰See *Sinn v. Burd*, 486 Pa. 146, 167, 404 A.2d 672, 683 (1979).

¹¹¹*Leong v. Takasaki*, 55 Hawaii 398, 407, 520 P.2d 758, 764 (1974); 486 Pa. at 167, 404 A.2d at 683.

¹¹²See *Spade v. Lynn & B.R.R.*, 168 Mass. 285, 288-89, 47 N.E. 88, 89 (1897).

¹¹³*Id.*

¹¹⁴*Id.*

¹¹⁵See *Watson v. Dilts*, 116 Iowa 249, 253, 89 N.W. 1068, 1070 (1902).

¹¹⁶Although the Massachusetts Supreme Court in *Spade v. Lynn & B.R.R.*, 168

takes into consideration the degree of moral culpability.¹¹⁷ However, drawing one straight black line between intentional and negligent infliction cases on the grounds of moral fault ignores the fine gradations of negligence.

Ancient Roman law divided conduct and accompanying duties into three classes. When a person was acting for his benefit alone, Roman law required him to exercise the greatest care and held him liable for the slightest neglect. When the performer was acting for the benefit of both himself and the injured party, he was held to a duty of ordinary care. When the person was acting for the sole benefit of another, he was not bound, by Roman law, to exercise much care.¹¹⁸ The duty approach here suggested is flexible enough to take into account these nuances.

In determining whether recovery for emotional distress should be allowed in either negligent or intentional infliction cases, one can scarcely ignore considerations of who between the two parties can better bear the loss, deterrence of future tortious conduct, and ease of administering the decision.¹¹⁹

The impact requirement, which Indiana courts previously imposed only in negligent infliction cases,¹²⁰ the zone of danger and foreseeability requirements which other jurisdictions impose only in negligent infliction cases,¹²¹ and the resultant physical injury requirement which most jurisdictions impose only in negligent infliction cases,¹²² do nothing to satisfy the reasons for the distinction between intentional and negligent infliction of emotional distress. Presence of impact, placement within the zone of danger, foreseeability alone, and resulting physical injuries do not make it reasonable to hold persons who are merely negligent bound to anticipate and guard against fright. Likewise, the imposition of these requirements in negligent infliction cases does not strengthen the probability that the alleged emotional distress is as genuine as it is in the intentional infliction cases. Use of these requirements merely serves to arbitrarily chop off liability rather than rationally limit it. The only analysis which takes into consideration all the reasons for differences in the intentional and negligent infliction cases is the

Mass. 285, 290, 47 N.E. 88, 89 (1897) stated that it is unreasonable to hold persons who are merely negligent responsible to anticipate and to guard against fright, it held that this proposition was a logical vindication of the impact rule.

¹¹⁷See notes 48-50 *supra* and accompanying text.

¹¹⁸See H. SMITH, LAW OF NEGLIGENCE 21 (2d ed. 1896).

¹¹⁹*Id.*

¹²⁰See notes 5-7 *supra* and accompanying text.

¹²¹See notes 59-62 *supra* and accompanying text.

¹²²See notes 70-71 *supra* and accompanying text.

duty approach, which considers all policy factors in determining whether imposition of liability is reasonable.

IV. CONCLUSION

What is advocated here is a reformation of the law: a tearing down of the artificial barriers to recovery which the courts have continually built and changed over the last century. The barriers have no relationship to the courts' legitimate fears. Adoption of the principles of duty in tort law would take into account these valid concerns and require that determinations be based upon them. Most, but not all, of the nation's jurisdictions recognize intentional infliction of emotional distress as an independent tort.¹²³ Only one jurisdiction has conferred independent tort status upon the negligent infliction of emotional distress.¹²⁴ Nevertheless, as one court has stated: "[w]hile recognizing the importance of *stare decisis* to our system of jurisprudence, we note at the same time that the strength of the common law has always been its responsiveness to the changing needs of society."¹²⁵ The changes in society are at hand. Through the development of modern medicine and psychiatry, problems of proof have been minimized.¹²⁶ The best response is to tear down the arbitrary barriers to recovery, recognize intentional and negligent infliction of emotional distress as independent torts, and let the balance of policy considerations in each case determine whether recovery should be allowed.

¹²³See note 94 *supra* and accompanying text.

¹²⁴See note 90 *supra* and accompanying text.

¹²⁵*Towns v. Anderson*, 195 Colo. 517, 519, 579 P.2d 1163, 1164 (1978).

¹²⁶See note 97 *supra* and accompanying text.

Section 482 and the Aftermath of *Foglesong*: The Beginning or the End for the Personal Service Corporation

PATRICIA S. BAILEY*

I. INTRODUCTION

Although Congress¹ and the individual state legislatures² apparently have long recognized the personal service corporation, the Internal Revenue Service continues to deny its corporate

*Associate, Indianapolis firm of Stark, Doninger, Mernitz, West & Smith.

¹For a brief history of the personal service corporation and congressional tax treatment, see Battle, *The Use of Corporations by Persons Who Perform Services to Gain Tax Advantages*, 57 TAXES 797, 801-02 (1979).

²See ALA. CODE §§ 10-4-220 to -239 (1980); ALASKA STAT. §§ 10.45.010-.140, .220 (1968 & Supp. 1981); ARIZ. REV. STAT. ANN. §§ 10-901 to -909 (1977); ARK. STAT. ANN. §§ 64-1701 to -1717 (medical corporations), 64-1801 to -1817 (dental corporations), 64-2001 to -2018 (professional corporations) (1980); CAL. CORP. CODE §§ 13400-10 (West 1977 & Supp. 1981); COLO. REV. STAT. §§ 12-2-101, -117 to -118, -131 (accounting), 12-33-124 (chiropractic), 12-36-134 (medical), 12-40-125 (optometric), 12-41-130 (physical therapy), 12-43-118 (psychological) (1978 & Supp. 1980); CONN. GEN. STAT. §§ 33-182a to -182j (Supp. 1981); DEL. CODE ANN. tit. 8, §§ 601-19 (1974 & Supp. 1980); D.C. CODE ANN. §§ 29-601 to -621 (1981); FLA. STAT. ANN. §§ 621.01-.15 (West 1977 & Supp. 1982); GA. CODE §§ 84-5401 to -5407 (1979 & Supp. 1981); HAWAII REV. STAT. §§ 416-141 to -154 (1976 & Supp. 1981); IDAHO CODE §§ 30-1301 to -1315 (1980 & Supp. 1981); ILL. REV. STAT. ch. 32, §§ 415-1 to -18 (Professional Service Corporation Act, P.A. 76-1283) (1979 & Supp. 1980); IND. CODE §§ 23-1-13-1 to -11 (general professional), 23-1-13.5-1 to -6 (accounting), 23-1-14-1 to -21 (medical), 23-1-15-1 to -21 (dental) (1976 & Supp. 1981); IOWA CODE §§ 496C.1-.22 (Supp. 1981); KAN. STAT. ANN. §§ 17-2706 to -2719 (1974 & Supp. 1980); KY. REV. STAT. ANN. §§ 274.005-.990 (1981); LA. REV. STAT. ANN. §§ 12:801-.815 (legal), 12:901-.915 (medical) (West 1969 & Supp. 1981), §§ 12:981-.995 (dental), 12:1011-.1012 (accounting), 12:1051-.1065 (chiropractic), 12:1071-.1085 (nursing), 12:1086-.1101 (architectural), 12:1110-.1124 (optometric), 12:1130-.1144 (psychological) (West Supp. 1981); ME. REV. STAT. ANN. tit. 13, §§ 701-716 (1981); MD. CORP. & ASS'NS CODE ANN. §§ 5-101 to -122 (1975 & Supp. 1981); MASS. GEN. LAWS ANN. ch. 156A, §§ 1-17 (West 1970 & Supp. 1981); MICH. COMP. LAWS §§ 450.221-.235 (1970); MINN. STAT. ANN. §§ 319A.01-.22 (West Supp. 1981); MISS. CODE ANN. §§ 79-9-1 to -27 (1972); MO. ANN. STAT. §§ 356.010-.200 (Vernon 1966 & Supp. 1982); MONT. REV. CODES ANN. §§ 15-2101 to -2116 (1967 & Supp. 1977); NEB. REV. STAT. §§ 21-2201 to -2222 (1977 & Supp. 1980); NEV. REV. STAT. §§ 89.010-.110 (1979); N.H. REV. STAT. ANN. §§ 294-A:1-.8 (Supp. 1973); N.J. STAT. ANN. §§ 14A:17-1 to -18 (West Supp. 1981); N.M. STAT. ANN. §§ 53-6-1 to -14 (1978); N.Y. BUS. CORP. LAW §§ 1501-16 (McKinney Supp. 1981); N.C. GEN. STAT. §§ 55B-1 to -15 (1975 & Supp. 1979); N.D. CENT. CODE §§ 10-31-01 to -14 (1976); OHIO REV. CODE ANN. §§ 1785.01-.08 (Page 1978 & Supp. 1981); OKLA. STAT. ANN. tit. 18, §§ 801-819 (West Supp. 1981); OR. REV. STAT. §§ 58.005-.365 (1973); PA. STAT. ANN. tit. 15, §§ 12601-12619 (Purdon 1967); R.I. GEN. LAWS §§ 7-5.1-1 to -12 (1969 & Supp. 1980); S.C. CODE §§ 33-51-10 to -170 (1976 & Supp. 1981); S.D. COMP. LAWS ANN. §§ 47-11-1 to -21 (medical), 47-12-1 to -21 (dental), 47-13-1 to -21 (veterinary) (1967 & Supp. 1981), 47-11A-1 to -20 (chiropractic), 47-11B-1 to -23 (optometric), 47-11C-1 to -23 (podiatric), 47-13A-1 to -10

existence.³ The war between the personal service corporation and the Service has been a longstanding one⁴ waged on numerous fronts,⁵ with battles and skirmishes won by both sides.⁶ The final battle, however, has not yet been fought; the war rages on.⁷

The personal service corporation has been defined as "a corporation whose income is to be ascribed to the activities of the principal owners or stockholders who are themselves regularly engaged in the active conduct of the affairs of the corporation and in which capital . . . is not a material income-producing factor" ⁸Falling within the ambit of this definition are the professional corporation, particularly the one "professional" situation,⁹ self-employed persons who incorporate,¹⁰ and members of a partnership who individually incorporate.¹¹

(legal), 47-13B-1 to -18 (accounting) (Supp. 1981); TENN. CODE ANN. §§ 48-2001 to -2007 (1979); TEX. REV. CIV. STAT. ANN. art. 1528e, §§ 1-20 (Vernon 1980); UTAH CODE ANN. §§ 16-11-1 to -15 (1973 & Supp. 1981); VT. STAT. ANN. tit. 11, §§ 801-813 (1973 & Supp. 1981); VA. CODE §§ 13.1-542 to -556 (1978 & Supp. 1981); WASH. REV. CODE ANN. §§ 18.100.010-.140 (1978); W. VA. CODE §§ 30-2-5-5a (legal), 30-3-15 (medical), 30-4-4b-4c (dental), 30-8-3a-3b (optometric), 30-9-4a (accounting), 30-10-18 (veterinary), 30-14-9a (osteopathic), 30-16-17 (chiropractic) (1980 & Supp. 1981); WIS. STAT. ANN. §§ 180.99(1)-(11) (West Supp. 1981), WYO. STAT. §§ 17-3-101,-102 (1977), 17-3-103, -104 (Supp. 1981).

³Keller v. Commissioner, [1981 Transfer Binder] TAX CT. REP. (CCH) No. 38,401, at 4183; Achiro v. Commissioner, [1981 Transfer Binder] TAX CT. REP. (CCH) No. 38,351, at 4089; Foglesong v. Commissioner, 35 T.C.M. (CCH) 1309 (1976), *rev'd and remanded*, 621 F.2d 865 (7th Cir. 1980), *on remand*, [1981 Transfer Binder] TAX CT. REP. (CCH) No. 38,423, at 4245.

⁴See, e.g., Kurzner v. United States, 413 F.2d 97 (5th Cir. 1969); O'Neill v. United States, 410 F.2d 888 (6th Cir. 1969); United States v. Kintner, 216 F.2d 418 (9th Cir. 1954); Laughton v. Commissioner, 40 B.T.A. 101 (1939), *remanded*, 113 F.2d 103 (9th Cir.), *dismissed*, 43 B.T.A. 1207 (1940); Fox v. Commissioner, 37 B.T.A. 271 (1938).

⁵See notes 14-16 *infra* and accompanying text.

⁶For example, the effectiveness of the sham corporation argument asserted in Laughton v. Commissioner, 40 B.T.A. 101 (1939), and Fox v. Commissioner, 37 B.T.A. 271 (1938), was severely reduced by the case of Moline Properties, Inc. v. Commissioner, 319 U.S. 436 (1943). See notes 49-52 *infra* and accompanying text. On the other hand, Ach v. Commissioner, 42 T.C. 114 (1964), *aff'd*, 358 F.2d 342 (6th Cir.), *cert. denied*, 385 U.S. 899 (1966), and Borge v. Commissioner, 405 F.2d 673 (2d Cir. 1968), represented a broad reading of the "two or more organizations, trades or businesses" requirement of section 482 and opened that section up to the Service as an alternative to the assignment of income doctrine.

⁷See Foglesong v. Commissioner, 35 T.C.M. (CCH) 1309 (1976), *rev'd and remanded*, 621 F.2d 865 (7th Cir. 1980), *on remand*, [1981 Transfer Binder] TAX CT. REP. (CCH) No. 38,423, at 4245.

⁸Revenue Act of 1918, ch. 18, § 200, 40 Stat. 1057, 1059 (1919).

⁹See generally McFadden, *Section 482 and the Professional Corporation: The Foglesong Case*, 8 J. CORP. TAX. 35, 35 (1981).

¹⁰See, e.g., Foglesong v. Commissioner, 35 T.C.M. (CCH) 1309 (1976), *rev'd and remanded*, 621 F.2d 865 (7th Cir. 1980), *on remand*, [1981 Transfer Binder] TAX CT. REP. (CCH) at 4245.

¹¹See, e.g., Keller v. Commissioner, [1981 Transfer Binder] TAX CT. REP. (CCH) at 4183.

The conflict posed by these corporations to taxing authorities is that while the shareholder-employee performs all the services, the corporation claims to have earned the income; failure to recognize this seeming paradox, however, constitutes a condemnation of the "corporateness" of the entity.¹² Thus, the primary issue is whether income earned from the services rendered should be taxed to the corporation or to the employee-shareholder who personally performed the service.¹³

In an effort to resolve the conceptual difficulties posed by these corporations and to ensure that the "true earner" is taxed, the Service has relied on a number of theories to ignore or bypass the corporation: sham corporation,¹⁴ assignment of income,¹⁵ and section 482.¹⁶ Arguing under the sham corporation theory, the Service asserts that the personal service corporation is merely a "dummy" or "alter ego" for the *true* taxpayer, the employee.¹⁷ Reliance on the assignment of income doctrine, which requires that income be taxed to the true earner,¹⁸ purportedly causes the same desirable result for the Service by shifting the income from the corporation back to the employee who actually *earned* it. Section 482 allows the Commis-

¹²The court in *Rubin v. Commissioner*, 429 F.2d 650 (2d Cir. 1970), aptly noted the problem.

[Personal service corporation] cases . . . reveal a tension between competing policies of the tax law. On one side is the principle of a graduated income tax, which is undercut when individuals are permitted to split their income with others or to spread it over several years. Opposing this is the policy of recognizing the corporation as a taxable entity distinct from its shareholders in all but extreme cases.

Id. at 652 (citations omitted).

¹³See *Battle*, *supra* note 1, at 801.

¹⁴See, e.g., *Morrison v. Commissioner*, 54 T.C. 758 (1970); *Noonan v. Commissioner*, 52 T.C. 907 (1969); *Laughton v. Commissioner*, 40 B.T.A. 101 (1939); *Fox v. Commissioner*, 37 B.T.A. 271 (1938).

¹⁵See, e.g., *Foglesong v. Commissioner*, 35 T.C.M. (CCH) 1309 (1976); *American Sav. Bank v. Commissioner*, 56 T.C. 828 (1971); *Rubin v. Commissioner*, 51 T.C. 251 (1968), *rev'd and remanded*, 429 F.2d 650 (2d Cir. 1970).

¹⁶See, e.g., *Keller v. Commissioner*, [1981 Transfer Binder] TAX CT. REP. (CCH) at 4183; *Achiro v. Commissioner*, [1981 Transfer Binder] TAX CT. REP. (CCH) at 4089; *Foglesong v. Commissioner*, 35 T.C.M. (CCH) 1309 (1976), *rev'd and remanded*, 621 F.2d 865 (7th Cir. 1980), *on remand*, [1981 Transfer Binder] TAX CT. REP. (CCH) at 4245; *Borge v. Commissioner*, 405 F.2d 673 (2d Cir. 1968); *Ach v. Commissioner*, 42 T.C. 114 (1964).

These are not the sole arguments raised by the Service against the personal service corporation. Other arguments include: substance over form, see, e.g., *Rubin v. Commissioner*, 51 T.C. 251 (1968), *rev'd and remanded*, 429 F.2d 650 (2d Cir. 1970), and section 269, see, e.g., *Achiro v. Commissioner*, [1981 Transfer Binder] TAX CT. REP. (CCH) at 4089; *Battle*, *supra* note 1, at 803.

¹⁷See notes 39-43 *infra* and accompanying text.

¹⁸*Lucas v. Earl*, 281 U.S. 111 (1930). See notes 61-67 *infra* and accompanying text.

sioner to reallocate income between two commonly controlled "organizations, trades, or businesses" to prevent tax avoidance or to clearly reflect income.¹⁹ The personal service corporation and its principal shareholder-employees have been held to meet this two business requirement and are thus subject to the provisions of section 482.²⁰ Unlike the other two judicially-created concepts, however, section 482 arguably maintains the integrity of the corporate entity.²¹

While the Service appears to prefer the assignment of income doctrine,²² the Second Circuit²³ and, more recently, the Seventh Circuit Court of Appeals²⁴ have rejected this means of allocating income and have indicated that the preferred method is that of using section 482.²⁵ Although commentators have suggested that section 482 might represent the death knell for the personal service corporation,²⁶ the Tax Court cases which have been decided since *Foglesong v. Commissioner* have indicated that section 482 may be the salvation for these entities struggling for simple recognition by taxing authorities of their validity.²⁷

This Article will briefly review the judicially-created methods used by the Service to attack the income distribution of the personal service corporation and will discuss those situations in which each method retains vitality. The development of section 482 as it affects the personal service corporation will be traced. An analysis of the *Foglesong* trilogy will be followed by a discussion of the Tax Court personal service corporation cases that have been decided since that Seventh Circuit decision. Finally, use of section 482 in these recent cases will be discussed in terms of future impact and effect on planning for the personal service corporation.

¹⁹I.R.C. § 482.

²⁰*See, e.g.,* Ach v. Commissioner, 42 T.C. 114 (1964).

²¹*See* Foglesong v. Commissioner, 621 F.2d 865 (7th Cir. 1980).

²²I.R.S. Letter Rul. Rep. (CCH) No. 8031028.

²³Rubin v. Commissioner, 51 T.C. 251 (1968), *rev'd and remanded*, 429 F.2d 650 (2d Cir. 1970), *on remand*, 56 T.C. 1155 (1971), *aff'd*, 460 F.2d 1216 (2d Cir. 1972).

²⁴Foglesong v. Commissioner, 35 T.C.M. (CCH) 1309 (1976), *rev'd and remanded*, 621 F.2d 865 (7th Cir. 1980), *on remand*, [1981 Transfer Binder] TAX CT. REP. (CCH) at 4245.

²⁵621 F.2d at 872; 429 F.2d at 653-54.

²⁶*See* Burdett, *Foglesong's Sec. 482 Approach May Threaten Closely-Held Personal Service Corporations*, 53 J. TAX. 330 (1980); Feuer, *Section 482, Assignment of Income Principles and Personal Service Corporations*, 59 TAXES 564 (1981); McFadden, *supra* note 9.

²⁷*See, e.g.,* Foglesong v. Commissioner, [1981 Transfer Binder] TAX CT. REP. (CCH) No. 38,423, at 4245; Keller v. Commissioner, [1981 Transfer Binder] TAX CT. REP. (CCH) No. 38,401, at 4183; Achiro v. Commissioner, [1981 Transfer Binder] TAX CT. REP. (CCH) No. 38, 351, at 4089.

II. COMMON LAW ATTACKS ON THE PERSONAL SERVICE CORPORATION

The arguments used by the Service reflect the progression of attitude, development, and understanding that the courts have displayed toward the personal service corporation through the years. Nonetheless, with every transition, setback, and defeat, the Service has always prepared a new strategy for attack when an old one loses momentum.

The conflict between one type of personal service corporation, the professional corporation, and the Service illustrates the attitude of ongoing antagonism. This background is included, by way of introduction to the other methods used by taxing authorities, to demonstrate the degree of commitment that the Service has shown to prove the "non-corporateness" of the personal service corporation.

The Service initially argued that corporate standing should be readily conferred on professional or personal service *associations*²⁸ because the corporate label carried greater tax liability.²⁹ Changes in the corporate tax laws, however, caused an attitude reversal by the Service toward these entities.³⁰ Nonetheless, the courts were not as eager as the Service to deny corporate status where it formerly had been recognized.³¹ To overcome this problem, the Service promulgated treasury regulations³² designed to limit the broad definition of corporation which had developed because of former regulations³³ and previous court decisions.³⁴ Professionals who were adversely affected responded by requesting assistance from the state legislatures; the swift answer was to permit professional associations to incorporate.³⁵ The Service countered with amended regula-

²⁸At that time, incorporating often was prevented by local law or professional ethics. However, associations offered many of the same benefits as corporate status. See generally B. BITTKER & J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* ¶ 2.06 (3d ed. 1971).

²⁹For an interesting synopsis of the government's approach to conferring the corporate label for federal tax purposes and its subsequent turnaround, see *Kurzner v. United States*, 413 F.2d 97, 100-01 (5th Cir. 1969). See generally Scallen, *Federal Income Taxation of Professional Associations and Corporations*, 49 MINN. L. REV. 603 (1965).

³⁰See *United States v. Kintner*, 216 F.2d 418 (9th Cir. 1954).

³¹See *id.*; *Foreman v. United States*, 232 F. Supp. 134 (S.D. Fla. 1964); *Galt v. United States*, 175 F. Supp. 360 (N.D. Tex. 1959).

³²Treas. Reg. §§ 301.7701-1 to -11, 26 C.F.R. §§ 301.7701-1 to -11 (1981). See *Kurzner v. United States*, 413 F.2d at 101, *citing* *United States v. Kintner*, 216 F.2d 418, 423 (9th Cir. 1954).

³³See, e.g., Treas. Reg. 111, §§ 29.3797-2,-4; 26 C.F.R. §§ 29.3797-2,-4 (1981).

³⁴See note 31 *supra*.

³⁵See *Kurzner v. United States*, 413 F.2d at 106. For a listing of the state statutes, see note 2 *supra*.

tions which stated that professional corporations were *not* corporations for federal tax purposes.³⁶ The court reaction to the amended regulations was uniformly unfavorable and the regulations were invalidated.³⁷

Having been ineffective at denying corporate status on the broad scale, the Service began attacking the professional corporation in the same manner that it had attacked other types of personal service corporations: by using the sham corporation and assignment of income arguments.

A. Sham Corporation

The sham corporation argument has undergone a metamorphosis with respect to the personal service corporation, but its function remains the same: to disregard the corporate entity and tax the income to the shareholder-employee(s).³⁸

Two early cases, *Fox v. Commissioner*³⁹ and *Laughton v. Commissioner*,⁴⁰ represent the genesis of the sham corporation argument. The issue raised was whether the personal service corporation should be disregarded as "a mere dummy"⁴¹ or as an "alter ego"⁴² of the shareholder-employee for federal tax purposes.⁴³ In *Fox*, Fon-

³⁶Treas. Reg. § 301.7701-1(c) (1965). The amended regulation added the following language:

Nevertheless, the labels applied by local law to organizations, which may now or hereafter be authorized by local law, are in and of themselves of no importance in the classifications of such organizations for the purposes of taxation under the Internal Revenue Code. Thus, a professional service organization, formed under the law of a State authorizing the formation by one or more persons of a so-called professional service corporation, would not be classified for purposes of taxation as a "corporation" merely because the organization was so labeled under local law. The classification in which a professional service organization belongs is determined under the tests and standards set forth in §§ 301.7701-2, 301.7701-3 and 301.7701-4.

Id.

³⁷*See, e.g.*, *Kurzner v. United States*, 413 F.2d 97 (5th Cir. 1969), *aff'g* 286 F. Supp. 839 (S.D. Fla. 1968); *O'Neill v. United States*, 410 F.2d 888 (6th Cir. 1969), *aff'g* 281 F. Supp. 359 (N.D. Ohio 1968); *United States v. Empey*, 406 F.2d 157 (10th Cir. 1969), *aff'g* 272 F. Supp. 851 (D. Colo. 1967); *Smith v. United States*, 301 F. Supp. 1016 (S.D. Fla. 1969); *Cochran v. United States*, 299 F. Supp. 1113 (D. Ariz. 1969); *Wallace v. United States*, 294 F. Supp. 1225 (E.D. Ark. 1968); *Holder v. United States*, 289 F. Supp. 160 (N.D. Ga. 1968).

³⁸*Compare* *Laughton v. Commissioner*, 40 B.T.A. 101 (1939) (alter ego or agent) and *Fox v. Commissioner*, 37 B.T.A. 271 (1938) (mere dummy) with *Noonan v. Commissioner*, 52 T.C. 907 (1969) (substantial business purpose).

³⁹37 B.T.A. 271 (1938).

⁴⁰40 B.T.A. 101 (1939).

⁴¹37 B.T.A. at 276.

⁴²40 B.T.A. at 105.

⁴³*Id.*; 37 B.T.A. at 276.

taine Fox, a noted cartoonist, formed a corporation of which he became president and majority shareholder, signed an employment contract with the corporation for his exclusive services at a designated salary, and transferred certain contracts for his cartoons and the copyrights of his cartoons to the corporation. The corporation,⁴⁴ in turn, contracted with others to distribute the cartoons in exchange for a percentage fee. In *Laughton*, a famous English actor, Charles Laughton, contracted to work five years exclusively for a corporation that he beneficially owned. The actor was paid a fixed salary. The corporation contracted with moving picture producers and studios for Laughton's talents and received the fruits of his labors.

In both cases, the Board of Tax Appeals relied on *New Colonial Ice Co., Inc. v. Helvering*.⁴⁵

As a general rule a corporation and its stockholders are deemed separate entities and this is true in respect of tax problems. Of course, the rule is subject to the qualification that the separate identity may be disregarded in exceptional situations where it otherwise would present an obstacle to the due protection or enforcement of public or private rights.⁴⁶

Finding no "exceptional situation" and noting that the corporations' identities had been respected, the Board found that the facts did not warrant the disregard of the corporate entity; thus, valid corporations existed for federal tax purposes.⁴⁷

The sham corporation argument as it existed in *Fox* and *Laughton* lost prominence in all but the most extreme situations⁴⁸ after the Supreme Court decided *Moline Properties, Inc. v. Commissioner*.⁴⁹ In that case, an individual transferred property to his corporation under a special mortgage arrangement. The property was later sold at a profit and the shareholder sought to have the gain taxed to him individually because of tax advantages. The Court found that the corporation was valid and taxed the gain to the corporation.⁵⁰

⁴⁴37 B.T.A. at 275. The board of directors was composed of Fontaine Fox (98 shares), president, C.E. Kelley (1 share), Fontaine's attorney and secretary of the corporation, and Barton Fox (1 share), his brother and treasurer. The stipulation of facts recognized that Fox "conducted the affairs of [the corporation]." *Id.*

⁴⁵292 U.S. 435 (1934).

⁴⁶*Id.* at 442 (citations omitted).

⁴⁷40 B.T.A. at 107; 37 B.T.A. at 277.

⁴⁸See notes 53-56 *infra* and accompanying text.

⁴⁹319 U.S. 436 (1943).

⁵⁰*Id.* at 440.

In reaching its decision, the Court established the standard by which to judge the existence of a corporation.

Whether the purpose be to gain an advantage under the law of the state of incorporation or to avoid or to comply with the demands of creditors or to serve the creator's personal or undisclosed convenience, so long as that purpose is the *equivalent of business activity* or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity.⁵¹

Although the Court did add the proviso that "the corporate form may be disregarded where it is a sham or unreal,"⁵² the sham corporation concept as it existed in *Fox* and *Laughton* lost vitality in the personal service corporation context.

Although the court in *Roubik v. Commissioner*⁵³ did not expressly find that the corporation involved was a sham, the case represents the type of extreme factual situation where the sham corporation attack could fairly be argued.⁵⁴ In *Roubik*, four radiologists had formed a professional corporation. The individuals, nonetheless, continued to contract personally with the institutions that were served; the corporation had no control over institutional assignments. No equipment was owned by the corporation and few operating expenses were incurred.⁵⁵ The concurring opinion aptly stated that the professionals had simply failed to "put flesh on the bones of the corporate skeleton"⁵⁶ Thus, in a factual context where the corporate "formalities" are respected, the sham corporation argument poses no serious threat to the personal service corporation.

⁵¹*Id.* at 438-39 (footnotes omitted) (emphasis added).

⁵²*Id.* at 439.

⁵³53 T.C. 365 (1969).

⁵⁴Judge Cudahy in *Foglesong v. Commissioner*, 621 F.2d 865 (7th Cir. 1980), commenting on the *Roubik* case, said: "In short, the corporate form was repeatedly flouted. Indeed, it would be fair to say that the corporation was not an operating enterprise and, in fact, to conclude (although the Tax Court did not do so in *haec verba*) that the corporation was a sham." *Id.* at 871.

⁵⁵53 T.C. at 379. The tax court stated:

Pfeffer Associates appears to have existed during 1965 as a mere set of bookkeeping entries and bank accounts. . . . It did not own any equipment, incur any debts for rent, office or medical supplies or services or for salaries, except for the salaries of the petitioners. The only "shared" expense . . . was \$45 a month for the time Ramin's Hampton office secretary devoted to maintaining records of income and expenses received and paid by Pfeffer Associates. The maintenance of these records for tax purposes appears to be the only real business activity engaged in by the corporation.

Id.

⁵⁶*Id.* at 382 (Tannenwald, J., concurring).

The sham corporation attack, however, did not die after *Moline Properties*; the weapon merely changed form.⁵⁷ The Service continues to present this attack generally in conjunction with its assignment of income argument.⁵⁸ The focus of its concern, however, is typically whether the personal service corporation has met the *Moline Properties* business activities test.⁵⁹

It should be noted, as the Tax Court recently did,⁶⁰ that there is a close relationship between the sham corporation and the assignment of income attacks, even when the prior is not presented: "Although [the Service] maintains that it is not Keller, Inc.'s classification as a corporation that is being disputed, but rather the determination of the true earner of the instant income which is in issue, this distinction is largely semantic rather than substantive."⁶¹

B. Assignment of Income

In the personal service corporation context, the assignment of income doctrine has been used to *bypass* the corporation and to tax the income to the "true earner," the employee.⁶² The desired result of this attack is the same as with the sham corporation argument, the corporation is ignored.⁶³

Denoted as "the first principle of income taxation,"⁶⁴ the assignment of income doctrine requires that income be taxed to the party who earned it.⁶⁵ The doctrine was first established in the landmark case of *Lucas v. Earl*⁶⁶ where the taxpayer, an attorney, contracted with his wife for joint ownership of everything they had or might acquire, including earnings. Thereafter, the husband only reported half of his income. Holding that the taxpayer was taxable on the entire income, Justice Holmes created the now-famous fruit and tree metaphor:

[T]his case is not to be decided by attenuated subtleties. It turns on the import and reasonable construction of the tax-

⁵⁷See note 38 *supra* and accompanying text.

⁵⁸See, e.g., *Foglesong v. Commissioner*, 35 T.C.M. (CCH) 1309 (1976).

⁵⁹See, e.g., *Morrison v. Commissioner*, 54 T.C. 758 (1970); *Noonan v. Commissioner*, 52 T.C. 907 (1969).

⁶⁰*Keller v. Commissioner*, [1981 Transfer Binder] TAX CT. REP. (CCH) No. 38,401, at 4183.

⁶¹*Id.* at 4194.

⁶²See, e.g., *Jones v. Commissioner*, 64 T.C. 1066 (1975); *American Sav. Bank v. Commissioner*, 56 T.C. 828 (1971); *Rubin v. Commissioner*, 51 T.C. 251 (1968), *rev'd and remanded*, 429 F.2d 650 (2d Cir. 1970).

⁶³See notes 60-61 *supra* and accompanying text.

⁶⁴*Commissioner v. Culbertson*, 337 U.S. 733, 739 (1949).

⁶⁵*Id.* at 739-40.

⁶⁶281 U.S. 111 (1930).

ing act. There is no doubt that the statute could tax salaries to those who earned them and provide that the tax could *not be escaped by anticipatory arrangements and contracts however skillfully devised to prevent the salary when paid from vesting even for a second in the man who earned it*. That seems to us the import of the statute before us and we think that no distinction can be taken according to the motives leading to the arrangement by which the fruits are attributed to a different tree from that on which they grew.⁶⁷

Thereafter, any arrangement which *even suggested* an artificial shifting of income was closely and often laboriously scrutinized. The personal service corporation by its very nature reeked with this suggestion.⁶⁸

With the exception of early cases,⁶⁹ the Tax Court has been very receptive to the assignment of income attack in the personal service corporation situation.⁷⁰ Some of the decided cases are unquestionably justifiable because the "employee" *was* the true earner.⁷¹ Other cases, however, are not easily reconciled without admitting that the corporate entity was completely ignored.⁷²

The "easy" cases epitomize the situation where either the requisite formalities were not followed or a law precluded certain corporate action, and therefore, the corporation could not have *earned* the income. In *Jones v. Commissioner*,⁷³ a federal court reporter

⁶⁷*Id.* at 114-15 (emphasis added).

⁶⁸The tax court in *American Sav. Bank v. Commissioner*, 56 T.C. 828 (1971), admitted its dilemma.

[T]he conceptually difficult arrangement where an individual performs services thereby earning the income that is received and the next day performs the same services and the compensation, when paid to a corporation wholly owned by that individual, is said to have been earned by the corporation. The patent artificiality of such a situation leads this Court to carefully scrutinize any such arrangement to assure that an individual is not merely siphoning off income to another entity at the expense of the public fisc.

Id. at 839.

⁶⁹*Laughton v. Commissioner*, 40 B.T.A. 101 (1939); *Fox v. Commissioner*, 37 B.T.A. 271 (1938).

⁷⁰See, e.g., *McIver v. Commissioner*, 36 T.C.M. (CCH) 719 (1977); *Foglesong v. Commissioner*, 35 T.C.M. (CCH) 1309 (1976); *Jones v. Commissioner*, 64 T.C. 1066 (1975); *Shaw v. Commissioner*, 59 T.C. 375 (1972); *American Sav. Bank v. Commissioner*, 56 T.C. 828 (1971); *Rubin v. Commissioner*, 51 T.C. 251 (1968). *But see* *Gettler v. Commissioner*, 34 T.C.M. (CCH) 442 (1975); *Estate of Cole v. Commissioner*, 32 T.C.M. (CCH) 313 (1973).

⁷¹See notes 73-79 *infra* and accompanying text.

⁷²See notes 87-93 *infra* and accompanying text.

⁷³64 T.C. 1066 (1975). *Jones* was also decided on the basis of section 482. *Id.* at 1077-79.

formed a corporation to conduct the business of court reporting. The court noted that the taxpayer had not assigned any of his rights or obligations as a court reporter to the corporation, and had not executed an employment contract. The court, however, relied primarily on a statute that required the court reporter *personally* to prepare, certify, and sell the transcripts.⁷⁴ Because the corporation could not itself be a court reporter, the court held that Mr. Jones was the true earner.⁷⁵ Likewise, in *McIver v. Commissioner*,⁷⁶ the taxpayer sought to have a brokerage commission taxed as income to his corporation which was not licensed as a real estate broker; the corporate receipt of the commission would have been a violation of the state law. Although the illegality of the transaction would not affect the taxation if it was indeed earned by the corporation, the court held that the income in this instance was earned by Mr. McIver functioning as a real estate broker and not as an agent of the corporation.⁷⁷ Finally, *Roubik v. Commissioner*⁷⁸ represents a case in which the corporation was permitted to do nothing and therefore could not have earned the income.⁷⁹

Most of the cases, however, do not fall into the "easy" category and their common conclusion that the corporation did not earn the income is not readily justified. Again *Fox*⁸⁰ and *Laughton*⁸¹ provide the historical backdrop, but also intensify the confusion.

In *Fox*, Fontaine Fox assigned all copyright interests in his cartoons to his corporation and signed an employment contract for his services to be rendered exclusively for his corporation. The corporation then contracted with third parties for Fox's services. The Board of Tax Appeals found that, because Fox had not personally contracted with third parties for his services and implicitly because he

⁷⁴*Id.* at 1076-77.

⁷⁵*Id.*

⁷⁶36 T.C.M. (CCH) 719 (1977).

⁷⁷*Id.* at 722-23.

⁷⁸53 T.C. 365 (1969). *Roubik* was not based on the sham corporation, although it represents the extreme situation where it would be appropriate, see notes 53-56 *supra* and accompanying text; the case was decided using the assignment of income doctrine. *Id.*

⁷⁹53 T.C. at 380-81. The *Roubik* court noted:

The corporation for instance did not hire the personnel *It* did not determine their salaries, or supervise them in their employments. Ramin did. . . . As a practical matter, Ramin's conduct of this office was a matter of indifference to the corporation, which served simply as a conduit for income and expense items. . . . [O]n the facts of the present case . . . the corporation, . . . had nothing to do with the earning of the amounts of income involved here.

Id. (emphasis in original).

⁸⁰37 B.T.A. 271 (1938).

⁸¹40 B.T.A. 101 (1939).

was contractually bound to the corporation, no assignment of income resulted.⁸²

In *Laughton*, Charles Laughton contracted to provide his exclusive services to the corporation in exchange for a fixed salary, subject to certain contracts that Laughton had previously executed with other production companies. Laughton assigned the profits of these contracts to the corporation in consideration for his employment contract. The corporation then contracted with production studios for the "loan" of its employee, although Laughton personally acknowledged in writing that "he obligated himself, individually, to render the services agreed upon by the studios and [the corporation]."⁸³ Finding this situation virtually indistinguishable from that in *Fox*⁸⁴ and noting that the only contract Laughton had with the corporation and the studios was "to consent to the performance of the services,"⁸⁵ the Board again held that there had been no assignment of income.⁸⁶ Both cases taxed the income to the corporation even though the predominant earnings were the result of the services of the shareholder-employee and that employee received a salary substantially less than he would have without the corporate structure.⁸⁷

While providing a weapon for the taxpayer, distinguishing these cases became an art for the Service. *Rubin v. Commissioner*⁸⁸ provided the first major opportunity following *Fox* and *Laughton* for

⁸²37 B.T.A. at 277-78. Following the creation of the corporation, Fox personally executed three contracts for the use of his cartoon characters in motion pictures, in toy manufacturing, and in advertising. All funds received pursuant to these contracts were used and reported by Fox. Subsequently, his attorney questioned the validity of the contracts because the corporation, not Fox, held the copyright at the time of contracting. Fox assigned the contracts to the corporation which reported the income thereafter. The court recognized that the assignment of the contracts constituted a transfer of income producing property and as such, income earned thereafter was properly taxed to the assignee, the corporation. *Id.* at 278.

⁸³40 B.T.A. at 104.

⁸⁴*Id.* at 106-07.

⁸⁵*Id.* at 106.

⁸⁶*Id.* at 106-07.

⁸⁷*Id.* at 105-07; 37 B.T.A. at 275-76. *Laughton* was appealed to federal court for consideration in light of the Supreme Court decision of *Higgins v. Smith*, 308 U.S. 473 (1940). *Commissioner v. Laughton*, 113 F.2d 103 (9th Cir. 1940). *Higgins* had recognized that an individual taxpayer could not sell stock to his "corporate self" at a loss for tax purposes. 308 U.S. at 475-76. Based on *Higgins*, the court remanded the case for consideration of "whether Laughton's hiring of himself to [the corporation] for a salary substantially less than the compensation for which the corporation supplied his services as its employee to various motion picture producers, constituted, in effect, a single transaction by Laughton in which he received indirectly the larger sum paid by the producers." 113 F.2d at 104. On remand, the case was settled by stipulation. See *Battle*, *supra* note 1, at 802 n.52.

⁸⁸51 T.C. 251 (1968).

head-to-head confrontation on the assignment of income question in the personal service corporation context.

In 1956, Richard Rubin, an officer of Rubin Bros., formed Park International, Inc., to help Dorman Mills, a good customer of the family corporation, to overcome some significant financial difficulties. Richard held 70% of the Park stock and his two brothers held the remaining 30%. Park contracted with Dorman Mills to provide a loan and management services in exchange for 25% of the annual net profits over \$25,000. Dorman Mills understood that Richard would personally perform the management services even though the contract did not expressly provide for such. During the same time, Richard individually contracted with the controlling shareholder of Dorman Mills for a four-year purchase option on the control block of stock and for the right to vote the stock during the option period. Within a few years, Dorman Mills made a slow recovery and began to show a profit. By 1959, it had repaid Park for the loan and was making payments under the contract terms. Park used the money to pay salaries and to purchase art for appreciation and for resale. The two brothers ran the art business while Richard, now Dorman Mills' controlling shareholder, continued to provide management under the contract until another corporation took over Dorman Mills in 1963.

The Tax Court found that Richard *worked* for *Dorman Mills* and that he gave portions of his *compensation* to Park as capital for the art business, using the substance-over-form doctrine.⁸⁹ The court recognized, however, that the same result could be reached using an assignment of income analysis.⁹⁰

Relying heavily on the joint work of two noted commentators,⁹¹

⁸⁹*Id.* at 265. The court noted the substance-form differentiation: "In form petitioner worked for Park, Park managed Dorman Mills, and the excess of the net Dorman Mills' fees over petitioner's salary remained in Park for use in its art business. . . . [I]n substance petitioner worked *directly* for Dorman Mills. . . ." *Id.* (emphasis added).

⁹⁰*Id.*

⁹¹Lyon & Eustice, *Assignment of Income: Fruit and Tree as Irrigated by the P.G. Lake Case*, 17 TAX L. REV. 295 (1962). Of "loaned employee" situations, the authors stated:

The distinction in these cases is grounded on the question of who has the ultimate direction and control over the earning of this compensation. If such control lies with the taxpayer who actually performs the services, then he remains taxable on the earnings from his personal services, whether or not he chooses to divert the receipt of that compensation to a third party. However, if the direction and control of the performer's activities resides in a superior authority, and the consideration paid for the performance of those services is made to the person having such ultimate direction and control, then the mere fact that the taxpayer has performed the services does not render him taxable on the amount paid for those services.

Id. at 393 (footnotes omitted), *quoted in* Rubin v. Commissioner, 51 T.C. 251, 265-66 (1968).

Interestingly, the authors were discussing loaned employees generally and the

the court noted that the crucial question in this context was "who controls the earning of the income."⁹² From this standpoint, the court easily concluded that the "employee" and not the corporation directed and controlled the earning, and therefore, earned the income.⁹³ Although *Fox* and *Laughton* were considered, the present fact situation was distinguished on two grounds: 1) the absence of an employment contract between Richard and Park; and 2) Richard's control of both parties to the transaction, Park and Dorman Mills.⁹⁴ Therefore, Richard was held personally taxable on the money that Dorman Mills had paid to Park under the contract terms.

Although *Rubin* was reversed and remanded on appeal,⁹⁵ the control concern introduced by the Tax Court gained prominence.⁹⁶ Given the nature of the personal service corporation, the control issue presented a powerful weapon to the Service. Suggestions have been made that employment contracts with covenants not to compete between the corporation and the shareholder-employee should be sufficient to overcome this argument;⁹⁷ the question, however, is unsettled.

The circuit court decisions in *Rubin* and most recently, in *Foglesong v. Commissioner*,⁹⁸ nonetheless, have introduced the questions of whether the assignment of income doctrine is appropriate for the personal service corporations, and if so, when it should be utilized.⁹⁹

The Second Circuit in *Rubin* found that the common law doctrines used by the tax court were "blunt tools."

References to "substance over form" and the "true earner" of income merely restate the issue in cases like this: Who is the "true earner"? What is substance and what is form? Moreover, they do so in a way which makes it appear

cited cases involved non-personal service corporations. See, e.g., *Wilgus v. Commissioner*, 20 T.C.M. (CCH) 752 (1961). *Fox* and *Laughton* were not cited or discussed. It is difficult to imagine how the broad statements of the authors could be reconciled with the *Fox* result.

⁹²51 T.C. at 265.

⁹³*Id.* at 266.

⁹⁴*Id.* at 266-67.

⁹⁵429 F.2d 650 (2d Cir. 1970).

⁹⁶See, e.g., *Foglesong v. Commissioner*, 35 T.C.M. (CCH) 1309 (1976); *Ronan State Bank v. Commissioner*, 62 T.C. 27 (1974); *Shaw v. Commissioner*, 59 T.C. 375 (1972); *American Sav. Bank v. Commissioner*, 56 T.C. 828 (1971).

⁹⁷See *Battle*, *supra* note 1, at 805; *Feuer*, *supra* note 26, at 567-68.

⁹⁸621 F.2d 865 (7th Cir. 1980).

⁹⁹See *id.* at 872; 429 F.2d at 653. See also *Keller v. Commissioner*, [1981 Transfer Binder] TAX CT. REP. (CCH) No. 38,401, at 4202-04 (Wilbur, J., dissenting).

that these questions can be answered simply by viewing the facts with appropriate suspicion.¹⁰⁰

After thus noting that the assignment of income doctrine was not well-designed for the personal service corporation, the court indicated that section 482 was a more precise tool and, indeed, was the appropriate means of solving the problems presented by these corporations.¹⁰¹ The appellate court also discussed the distinguishing features between the *Rubin* facts and those in *Fox*.¹⁰² The court found them to be irrelevant with respect to the common law doctrines relied on by the Tax Court.¹⁰³

In *Foglesong v. Commissioner*, the Seventh Circuit, bolstered by the *Rubin* decision, also found the common law techniques to be an awkward means to accomplish their purposes.¹⁰⁴ In so doing, the court explicitly recognized that the assignment of income doctrine was used to disregard the corporation through the balancing of tax avoidance motives and legitimate business purposes.¹⁰⁵

Such an approach places too low a value on the policy of the law to recognize corporations as economic actors except in exceptional circumstances. This is true whether the analysis used to *dismantle the corporation* pursues the rubric of assignment of income or substance over form. Here there are other more precise devices for coping with the unacceptable tax avoidance *But there is no need to crack walnuts with a sledgehammer.*¹⁰⁶

The court determined that section 482 would be a better method to accomplish the same purpose without losing the integrity of the entity.¹⁰⁷

The *future* of the common law doctrines with respect to personal service corporations generally is uncertain as is the *present* in the Tax Courts in the Second and Seventh Circuits.¹⁰⁸ Even where the common law doctrines maintain some vitality, the *Rubin* and

¹⁰⁰429 F.2d at 653 (emphasis added).

¹⁰¹*Id.* at 653-54.

¹⁰²See note 94 *supra* and accompanying text.

¹⁰³429 F.2d at 654.

¹⁰⁴621 F.2d at 869, 872.

¹⁰⁵*Id.*

¹⁰⁶*Id.* at 872 (emphasis added).

¹⁰⁷*Id.* at 872-73. The court recognized the validity of the corporation and found that the "corporate tree seems sturdy enough to become fruit-bearing, subject, of course, to whatever pruning (radical or otherwise) by the tax collector appears appropriate." *Id.* at 873.

¹⁰⁸See, e.g., *Keller v. Commissioner*, [1981 Transfer Binder] TAX CT. REP. (CCH) at 4183.

Foglesong reasoning may be used as an effective weapon against them. With increasing regularity, the Service will need to be armed with section 482.

III. THE ARMOR OF SECTION 482

Concern has been expressed as to which of the "opponents" is benefited by section 482.¹⁰⁹ Is this the ultimate and invulnerable weapon of the Internal Revenue Service?¹¹⁰ Or has the personal service corporation finally found a strong defense against the Service attacks? The answer, if there is one, lies in an understanding of the provision itself and with the courts' interpretation and application of the statute.

A. *The Purpose and Effect of Section 482*

Section 482 provides:

In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.¹¹¹

The statute is designed to put the controlled taxpayer on equal *tax* footing with the uncontrolled taxpayer¹¹² and to prevent "artificial shifting, milking, or distorting of the true net incomes of commonly controlled enterprises."¹¹³ To determine if reallocation is necessary, the controlled taxpayer is judged by the standard of arm's length dealing or of two uncontrolled taxpayers dealing with one another.¹¹⁴

The section envisions the correction of *two* different problems.

¹⁰⁹See note 26 *supra* and accompanying text.

¹¹⁰The dissenting justice in *Commissioner v. First Sec. Bank*, 405 U.S. 394 (1972), suggested that section 482 was "a sharp two-edged *tool* fashioned and bestowed by the Congress upon the Internal Revenue Service . . ." *Id.* at 426 (Blackmun, J., dissenting) (emphasis added).

¹¹¹I.R.C. § 482.

¹¹²Treas. Reg. § 1.482-1(b)(1), 26 C.F.R. § 1.482-1(b)(1) (1981).

¹¹³B. BITTKER & J. EUSTICE, *supra* note 28, ¶ 15.06, at 15-21.

¹¹⁴Treas. Reg. § 1.482-1(b)(1), 26 C.F.R. § 1.482-1(b)(1) (1981).

The first concerns the intentional violation of the tax laws and the resulting evasion of taxes.¹¹⁵ The second, however, implies no improper motive or illegality, but merely recognizes that shifts may be necessary to clearly reflect income when the same interests control two enterprises.¹¹⁶ In each instance, the Commissioner is authorized to adjust the income between the two controlled entities to correct either type of problem.

Section 482 allocations, however, are less onerous than allocations using the assignment of income doctrine, even when the same amount is involved, because of the effect of constructive dividends in the latter situation.¹¹⁷ If an adjustment is made pursuant to section 482, the amount that has been added to the "employee's" income for tax purposes may be withdrawn from the corporation without tax consequence.¹¹⁸ The assignment of income allocation, however, does not permit the same benefit. Any withdrawal of funds, including those on which the taxpayer has paid taxes due to the allocation, is considered a dividend.¹¹⁹ The employee, therefore, is subject to a double tax if he attempts to obtain from the corporation funds which have been labelled "his income" by the Service.

Although section 482 provided some flexibility which the assignment of income doctrine did not offer, the section became operative only when three requirements were met: 1) two or more organizations, trades, or businesses; 2) common control; and 3) income distortion. These requirements were initially thought to prevent the application of the section to the personal service corporation.¹²⁰ This was not the case.

B. Section 482 and the Personal Service Corporation

The idea of using section 482 with the personal service corporation did not originate with the circuit court decisions of *Rubin* and *Foglesong*. By the time those cases decided that section 482 was the preferred method, its application in the context was an accepted proposition to the Tax Court. The early cases were fraught with problems, however, the most significant of which was how to meet the initial requirement of two controlled "*organizations, trades, or businesses*."¹²¹

¹¹⁵See, e.g., *Commissioner v. First Sec. Bank*, 405 U.S. 394, 419 (1972) (Blackmun, J., dissenting).

¹¹⁶See B. BITTKER & J. EUSTICE, *supra* note 28, ¶ 15.06, at 15-21.

¹¹⁷See *Battle*, *supra* note 1, at 807-08.

¹¹⁸Treas. Reg. § 1.482-1(b), 26 C.F.R. § 1.482-1(b) (1981).

¹¹⁹See *Battle*, *supra* note 1, at 807-08.

¹²⁰See *Ach v. Commissioner*, 42 T.C. 114 (1964), *aff'd*, 358 F.2d 342 (6th Cir.), *cert. denied*, 358 U.S. 899 (1966).

¹²¹See notes 121-36 *infra* and accompanying text.

Ach v. Commissioner,¹²² the first case to apply section 482 to a personal service situation, represented a sympathetic case for the broadening of the statutory language; it, thus, formed the necessary foundation for later, more significant steps. In *Ach*, Pauline Ach was the owner and operator of a successful dress shop. Her son, Roger, operated a failing dairy corporation which was indebted in excess of \$250,000 to Earnest Ach, Roger's father, who had covered yearly losses. In 1953, the corporation changed its name, expanded its stated purpose, and discontinued the dairy business. Although not a shareholder at the time, Pauline was voted president, treasurer, and board chairman of the new family corporation. She then sold to the corporation her dress business for its stated book value, an amount approximately equal to one year's net profit. Even though Pauline continued to operate the business as she had before, she received no salary from either enterprise. The corporate profits, earned from the dress shop, were used to pay the price of the dress business and to repay the indebtedness of the dairy business. No taxes were owed because of the carry-over losses from the dairy, and Pauline paid no income tax because she received no salary.

The Tax Court noted that Pauline, because of her ownership and operation of the business, had *been* "a taxpayer of the character referred to in section 482," prior to the sale.¹²³ The sale of the business, however, constituted only the transfer of the "naked assets" to the corporation which did *not* encompass the transfer of "Pauline's active participation as manager and guiding spirit."¹²⁴ The court thus concluded that "sufficient aspects of the business remained with Pauline so as not to deprive her of the status of a separate 'organization,' 'trade,' or 'business' within the meaning of section 482."¹²⁵ Once that hurdle was surmounted, the court had no difficulty finding common control and distortion of income.¹²⁶

Using section 482, the court established that Pauline should be taxed on 70% of the profits from the dress business, the amount determined to be attributable to Pauline's services.¹²⁷

Because the tax avoidance motives were so apparent and the end result was equitable, the *Ach* extension did not immediately cause the uproar that revolutionary change usually generates. The next case, *Borge v. Commissioner*,¹²⁸ likewise involved tax

¹²²42 T.C. 114 (1964), *aff'd*, 358 F.2d 342 (6th Cir.), *cert. denied*, 385 U.S. 899 (1966).

¹²³42 T.C. at 124.

¹²⁴*Id.*

¹²⁵*Id.* at 125.

¹²⁶*Id.* at 125-26.

¹²⁷*Id.* at 127. The remaining 30% was attributable to the corporation which owned the assets and paid the employees.

¹²⁸405 F.2d 673 (2d Cir. 1968).

avoidance.¹²⁹ Victor Borge, a famous entertainer, funneled his substantial entertainment income through his corporation which had also acquired his poultry business, a perpetually losing venture. Borge received a comparatively small salary pursuant to his five-year employment contract with his corporation. The corporation "did nothing to aid Borge in his entertainment business."¹³⁰

The court found that Borge "owned or controlled two businesses, an entertainment business and a poultry business" for the purposes of section 482.¹³¹ Borge relied on the Supreme Court case of *Whipple v. Commissioner*¹³² which held that rendering services to a corporation as an investment was not sufficient to meet the requirements of a trade or business.¹³³ The court, however, was not persuaded by the investment argument but indicated that Borge entertained as a career and as his *primary* business.¹³⁴ After finding section 482 to apply, the court affirmed the Commissioner's allocation of \$75,000 per year to Borge from his corporation.¹³⁵ This was still less than *half* of Borge's average annual net entertainment income.¹³⁶

After the *Borge* decision, the clamor of concern and fear came.¹³⁷

¹²⁹*Id.* Unlike in many of the other cases discussed, Borge was attempting to use the corporate structure to avoid application of another code provision, section 270.

¹³⁰*Id.* The appellate court accepted the lower court's findings:

that Borge operated an entertainment business and merely assigned to Danica a portion of his income from that business; that *Danica did nothing to earn or to assist in the earning of the entertainment income*; that Borge would not have contracted for \$50,000 per year with an unrelated party to perform the services referred to in his contract with Danica.

Id. at 676 (emphasis added). Interestingly, the court in its presentation of facts noted that it was the corporation that contracted with third parties for Borge's services, although Borge's personal guarantee was also frequently required. *Id.* at 675. Given this corporate involvement, the conclusion that Danica did nothing to earn or to assist in the earning of income is difficult to justify without completely ignoring the realities of corporate existence.

¹³¹*Id.* at 675-76.

¹³²373 U.S. 193 (1963).

¹³³*Id.* at 202. The Court noted:

Devoting one's time and energies to the affairs of a corporation is *not of itself, and without more*, a trade or business of the person so engaged. Though such activities may produce income, profit or gain in the form of dividends or enhancement in the value of an investment, this return is distinctive to the process of investing and is generated by the successful operation of the corporation's business as distinguished from the trade or business of the taxpayer himself.

Id. (emphasis added).

¹³⁴405 F.2d at 676.

¹³⁵*Id.* at 677. The Commissioner actually allocated \$75,000 yearly for 1958-1961 and \$25,000 for 1962, the only year Borge was paid the \$50,000 stipulated salary. *Id.*

¹³⁶*Id.* at 677.

¹³⁷See Aland, *Section 482: 1971 Version*, 49 TAXES 815, 848 (1971); Fuller, *Section*

The implication of *Ach* and especially of *Borge* was that employment status alone was sufficient to create a trade or business.¹³⁸ The logical extension and the growing fear, therefore, was that section 482 could be used liberally to reallocate income whenever the Commissioner considered a corporate employee's salary inadequate.¹³⁹ It appeared that the Service had added its strongest weapon to the arsenal.

These fears did not subside with the addition of *Rubin v. Commissioner*.¹⁴⁰ On remand, after the Second Circuit found that section 482 was superior to the common law methods,¹⁴¹ the Tax Court was not persuaded that the *Rubin* facts were significantly distinguishable from those in *Ach* and particularly from those in *Borge*.¹⁴² The existence of a business prior to forming the corporation, as was the situation in both earlier cases, was not deemed to be of any more importance than merely a factor to be weighed in the trade or business determination.¹⁴³ Nor was the court moved by the variance in purpose between the corporations in *Ach* and *Borge* and the *Rubin* corporations; the lack of improper motives was insignificant.¹⁴⁴ The court further noted that in many ways *Rubin* presented a stronger case for section 482 application because of the absence of an employment contract with a covenant not to compete and because of the failure to relinquish any control of income production.¹⁴⁵ Although the court found that the existence of other shareholders who had made substantial capital contributions was a favorable factor, this did not influence the applicability of the statute. Instead it influenced the actual allocation.¹⁴⁶

Perhaps most significantly, the court stated: "We rely on *Borge* for the proposition that assignment-of-income principles may be employed to the limited extent of supporting the existence of a trade or business on the part of a shareholder who purportedly acts as a corporate employee in conducting his business affairs."¹⁴⁷ With the control question directing assignment of income principles,¹⁴⁸ the

482 Revisited, 31 TAX L. REV. 475, 477-81 (1976); Seieroe & Gerber, *Section 482—Still Growing at the Age of 50*, 46 TAXES 893, 895-97 (1968).

¹³⁸See, e.g., Seieroe & Gerber, *supra* note 137, at 895-97.

¹³⁹See, e.g., *Rubin v. Commissioner*, 56 T.C. 1155 (1971), *aff'd*, 460 F.2d 1216 (2d Cir. 1972).

¹⁴⁰56 T.C. 1155 (1971).

¹⁴¹See notes 100-03 *supra* and accompanying text.

¹⁴²56 T.C. at 1157-59.

¹⁴³*Id.* at 1159.

¹⁴⁴*Id.*

¹⁴⁵*Id.* at 1160.

¹⁴⁶*Id.*

¹⁴⁷*Id.* at 1162.

¹⁴⁸See note 96 *supra* and accompanying text.

conclusion is unavoidable that the controlling shareholder-employee will always be a trade or business¹⁴⁹ and the closely-held personal service corporation will always be subject to allocation by the Commissioner under section 482 *if there is a distortion of income*.

The *Rubin* court found a distortion of income and charged Richard Rubin's income with additional amounts.¹⁵⁰ Unfortunately, the court did not demonstrate how it arrived at the figures; however, the amounts were far less than the original stipulated allocation at the first *Rubin* trial.¹⁵¹

Thereafter, many of the courts fortunate enough to have a choice treated *Rubin* as an anomaly, ignoring it whenever possible, and continued instead to follow the time-honored, traditional common law doctrines.¹⁵² Even the Service presented the common law arguments as its primary line of attack and kept section 482 as secondary reinforcement.¹⁵³

The concept that *Rubin* represented a major deviation from mainstream judicial thought, however, lost some force when the Seventh Circuit agreed in *Foglesong v. Commissioner* with the Second Circuit's reasoning.¹⁵⁴ This fact in conjunction with the fact situation in which *Foglesong* arose did create immense concern about the future of the personal service corporation.¹⁵⁵

Prior to incorporation, Foglesong was a sales representative for two separate steel tubing manufacturers. He was responsible for persuading potential customers to use the products of his "employ-

¹⁴⁹When confronted with the potential impact, the Tax Court indicated it was not holding that "employment status constitutes, in and of itself, a trade or business within the meaning of section 482." 56 T.C. at 1161. Instead, it asserted that the holding was "limited" to when the facts justify the conclusion "that a shareholder operated an independent business and merely assigned to the corporation a portion of the income therefrom, the business activity of the taxpayer may constitute a trade or business" *Id.*

On its second appeal to the circuit court, Richard Rubin argued that the Tax Court decision had created a "parade of horrors wherein the Commissioner would utilize § 482 to reallocate income so as to increase the salaries of all employees of controlled corporations whom he believes to have been intentionally underpaid." 460 F.2d 1216, 1218 (2d Cir. 1972). The court's response indicates its general lack of discomfort with the asserted proposition: "Although the prospect is not so shocking to us as to counsel, we find no need either to embrace or to reject the general proposition which the taxpayer limns." *Id.*

¹⁵⁰56 T.C. at 1164.

¹⁵¹Compare *id.* with 51 T.C. 251, 264 (1968).

¹⁵²*E.g.*, *American Sav. Bank v. Commissioner*, 56 T.C. 828, 839 n.10 (1971) (inapplicability of section 482 agreed by stipulation of the parties).

¹⁵³*E.g.*, *Foglesong v. Commissioner*, 35 T.C.M. (CCH) 1309 (1976).

¹⁵⁴See, *e.g.*, *Achiro v. Commissioner*, [1981 Transfer Binder] TAX CT. REP. (CCH) No. 38,351, at 4089; *Keller v. Commissioner*, [1981 Transfer Binder] TAX CT. REP. (CCH) No. 38,401, at 4183.

¹⁵⁵See Burdett, *supra* note 26; Feuer, *supra* note 26; McFadden, *supra* note 9.

ers," to answer technical questions, and following a purchase, to continue to answer concerns and to service complaints. In August of 1966, he incorporated his business; he held 98 shares of common stock while his wife and his accountant had one share apiece. Also, his four young children became preferred shareholders; the subscription price of \$400 was paid by Foglesong. Foglesong informed the manufacturers of the incorporation and of his desire for all future commissions to be paid to the corporation. The manufacturers agreed, although new contracts were not executed for several years. From September to December of 1966, Foglesong received no salary from the corporation, although the corporation received commissions for the period. During the next few years, he received a salary that was much less than the total commissions paid to the corporation as a result of his efforts. No employment contract with a covenant not to compete was executed between Foglesong and the corporation. The corporation, in addition, paid a dividend on its preferred stock only, totalling a sum of \$38,000¹⁵⁶ for the years 1967-70.

The Tax Court relied primarily on Foglesong's total control and his obvious tax avoidance motives to find that 98% of the income was taxable to him personally.¹⁵⁷ The Seventh Circuit Court of Appeals found that the Tax Court, although "strongly influenced by the apparent flagrancy of the tax avoidance," had "substantially disregarded the Corporation for tax purposes"¹⁵⁸ under the guise of assignment of income principles; the court reversed and remanded for redetermination using section 482.¹⁵⁹

Following the Seventh Circuit's decision, the legal forecasters predicted that, regardless of some favorable language in the opinion, the fate of the personal service corporation had been sealed.¹⁶⁰ The final battle had been fought, and although the corporations had struggled valiantly, refusing to surrender, the Service had won the war. Interestingly, the results predicted on remand turned out to be reality.¹⁶¹ Two cases that were decided by the Tax Court during the interim period between the reversal and the remand, however, cast a different light on *Foglesong* and on the impact of section 482 in general.¹⁶²

¹⁵⁶See 621 F.2d at 866 n.3.

¹⁵⁷35 T.C.M. (CCH) at 1313-14.

¹⁵⁸621 F.2d at 867.

¹⁵⁹*Id.* at 873.

¹⁶⁰See, e.g., Burdett, *supra* note 26, at 334.

¹⁶¹See Burdett, *supra* note 26, at 334-35; McFadden, *supra* note 9, at 36.

¹⁶²*Achiro v. Commissioner*, [1981 Transfer Binder] TAX CT. REP. (CCH) No. 38,351, at 4089; *Keller v. Commissioner*, [1981 Transfer Binder] TAX CT. REP. (CCH) No. 38,401, at 4183.

IV. THE DIRECTION AND FUTURE AFTER *Foglesong*

Because the closely-held personal service corporation has been held to meet the requirement of two commonly controlled "organizations, trades or businesses," then section 482 applies *if* there is a distortion of income.¹⁶³ The critical question, therefore, has shifted from a concern with trades and businesses to a consideration of income and distortion. To determine distortion, the courts have relied on the arm's length test.¹⁶⁴ Prior to applying this rule, however, the concept of income and its parameters must be defined.

A. *Income*

To determine whether income has been distorted, the employee-shareholder includes *both* his salary *and* the corporate contributions to his benefit plans.¹⁶⁵ One case, however, indicates that if the sole reason for establishing a personal service corporation is to gain the benefits of such plans and no other income distortion exists, the use of section 482 is not justified at all.¹⁶⁶

1. *Incorporation for Benefit Plans.*—In *Achiro v. Commissioner*,¹⁶⁷ the Service argued that "incorporation for the principal purpose of taking advantage of corporate pension and profit-sharing plans amounts to an evasion or avoidance of income taxes, an unclear reflection of income, and/or an assignment of income."¹⁶⁸ The Tax Court held that although the petitioners incorporated primarily to obtain benefits, section 482 did not apply.¹⁶⁹

In this case, both Achiro and Rossi, the petitioners, served as officers, managers, and 50% owners of Tahoe City Disposal, a corporation that operated a waste collection business. They also each acquired 25% ownership and management responsibility for Kings Beach Disposal Co., Inc. Both corporations employed additional personnel.¹⁷⁰ In late 1974, Achiro and Rossi, in conjunction with Achiro's wife and his brother, formed A & R Enterprises, Inc., with the brother owning 52% of the stock¹⁷¹ and Achiro and Rossi owning the

¹⁶³See notes 147-49 *supra* and accompanying text.

¹⁶⁴Treas. Reg. § 1.482-2(b)(1)-(3) 26 C.F.R. § 1.482-2(b)(1)-(3) (1981). See also notes 182-84 *infra* and accompanying text.

¹⁶⁵*Keller v. Commissioner*, [1981 Transfer Binder] TAX CT. REP. (CCH) at 4183, 4190-91.

¹⁶⁶*Achiro v. Commissioner*, [1981 Transfer Binder] TAX CT. REP. (CCH) at 4101.

¹⁶⁷[1981 Transfer Binder] TAX CT. REP. (CCH) at 4089.

¹⁶⁸*Id.* at 4098.

¹⁶⁹*Id.* at 4101.

¹⁷⁰Tahoe City Disposal employed between nine and eleven additional people during 1975-77 while Kings Beach Disposal employed three to four people. *Id.* at 4091.

¹⁷¹Although the brother was the majority shareholder, he had very little contact

remainder equally. The corporate purpose was to provide management, consulting and advisory services. Twenty-year contracts for these services were made between this new corporation and the two waste collection corporations. Also, A & R executed employment contracts with Achiro and Rossi for five years of exclusive service. A salary and benefit plan provided the agreed compensation. Within a month, a profit-sharing plan and a pension plan were in effect for the two sole employees. The contributions to the A & R plans were substantially greater than that provided in comparable plans offered by the other two corporations.¹⁷²

In response to the obvious scheme for higher qualified benefits, the Commissioner had allocated all service income from A & R to Tahoe City Disposal and Kings Beach Disposal using section 482.¹⁷³ After noting the purpose of section 482 and the prominent cases, the Tax Court found the section inapplicable.¹⁷⁴ The court, however, immediately hedged and noted that if the section was used in this situation, the allocations must be reasonable in light of the arm's length guidelines; the current transaction represented arm's length charges for the service rendered.¹⁷⁵

There are a number of possible explanations and interpretations for the court's holding on section 482. The court may have been willing to find section 482 inapplicable because another code section corrected the real problem more directly. The major problem in this instance was not income distortion *between the three corporations*, but an obvious attempt to maximize the corporate tax benefits for Achiro and Rossi without complying with the nondiscrimination re-

with or control of the management of the corporation, outside of offering some free advice on an infrequent basis. It was understood that he would *not* vote his stock or vote according to the direction of Silvano Achiro. *Id.* at 4091, 4094.

¹⁷²*Id.* at 4904. The stipulation of facts provided a comparative chart:

	A & R		North Tahoe
	Profit Sharing	Pension	P-S Plan
Eligibility	No service requirement	No service requirement	One year of service
Vesting	100% upon participation	100% upon participation	10% after first year, 10% each additional year, until 100%
Contributions	Employers's discretion but not to exceed deductible amounts	10% of compensation	Employer's discretion but not to exceed deductible amounts

Id.

¹⁷³*Id.*

¹⁷⁴*Id.* at 4101.

¹⁷⁵*Id.*

quirements for the waste collection corporations.¹⁷⁶ The court was able to rectify this difficulty using sections 401 and 414;¹⁷⁷ thus, contributions to the A & R plans were includible in the gross incomes of Achiro and Rossi.¹⁷⁸ The Service, additionally, was attempting to use section 482 to reallocate income among the three corporations, instead of between the personal service corporation and its employees. The court clearly saw no distortion of income among the corporations,¹⁷⁹ but it may have been more receptive to the section 482 appeal if the reallocation was between Achiro, Rossi, and A & R. Indeed, all the cases examined by the court were inadequate compensation cases.¹⁸⁰ The limiting language of the court may have been included to meet this contingency. The court also may have intended only to clarify that it might entertain section 482 arguments where incorporation is primarily to obtain benefits if other indicia of income distortion are present.

Although the true impact of *Achiro* is unclear, incorporation for the primary purpose of taking advantage of corporate benefit plans alone does not automatically "trigger" section 482. This construction is fortified by *Keller v. Commissioner*.¹⁸¹

2. *Effect of Benefits on Income.*—*Keller v. Commissioner* dealt with the more typical application of section 482 to a personal service corporation. Although the fact situation is complex and will be described in detail at a later point, for the purposes of this discussion, a summary presentation will suffice.

Keller, a pathologist, was a general partner with several pathologists. He received a share of the profits as income. When he became concerned about his family's financial future, he was advised

¹⁷⁶Certainly, one of the major purposes of the corporation was to permit adoption of benefit plans that would discriminate in favor of the petitioners and yet qualify under section 401 for exclusion from gross income. *Id.* at 4103, 4105.

¹⁷⁷*Id.* The court required aggregation of employees between A & R and the Tahoe City Disposal pursuant to section 414. Notably, the distribution of the 52% ownership to the brother, the sole purpose of which was to avoid this result, was ineffective to prevent the aggregation. Because of the agreement not to vote or to vote in compliance with the wishes of Achiro, the voting rights of the brother were either disregarded or attributed to Achiro in determining whether a controlled group of corporations existed. *Id.*

¹⁷⁸*Id.* at 4105.

¹⁷⁹*Id.* at 4101.

¹⁸⁰*Id.* at 4099-100. The court examined *Borge v. Commissioner*, 405 F.2d 673 (2d Cir. 1968), *Jones v. Commissioner*, 64 T.C. 1066 (1975), [1981 Transfer Binder] TAX CT. REP. (CCH) No. 38,401, at 4183, *Rubin v. Commissioner*, 51 T.C. 251 (1968), *rev'd and remanded*, 429 F.2d 650 (2d Cir. 1970), *on remand*, 56 T.C. 1155 (1971), *aff'd*, 460 F.2d 1216 (2d Cir. 1972), and *Ach v. Commissioner*, 42 T.C. 114 (1964), *aff'd*, 358 F.2d 342 (6th Cir. 1966).

¹⁸¹[1981 Transfer Binder] TAX CT. REP. (CCH) at 4183.

to form a corporation to run his pathology practice. The corporation, which thereafter served in Keller's place as a general partner, adopted several benefit plans as well as executing an employment contract with Keller. The Service attempted to have all the income received by the corporation taxed to Keller individually based on the assignment of income doctrine or section 482.

The Tax Court found section 482 applicable.¹⁸² It also recognized that the appropriate comparison figure for the arm's length determination was the "total compensation package,"¹⁸³ including corporate contributions to benefit plans.¹⁸⁴ Significantly, the court went on to note that the benefits were "probably worth more to petitioner than any equivalent payment he would have received outright."¹⁸⁵ The footnote indicated that the court was specifically referring to the tax reduction consequences of these plans.¹⁸⁶

The importance of this assertion and this aspect of the case can only be appreciated if the arm's length test is understood. The concern under this test is whether income of the employee is "essentially equivalent" to his income absent incorporation.¹⁸⁷ Of course, the major problem, especially obvious in the one-person personal service corporation context, is that the corporation's sole employee received *all* the income before incorporation.

[O]ne would expect petitioner, in an arm's-length transaction with an unrelated party, to have bargained for a total compensation package which would approximate the amounts he previously received as a sole proprietor. One would similarly expect that petitioner's total compensation would also reflect any increase in [the partnership's] earnings over and above the pre-incorporation years. To the extent of any meaningful disparity between these amounts, it is our view that the Commissioner is correspondingly justified in making an adjustment in petitioner's income to properly reflect the true taxable income he earned¹⁸⁸

Under this test, any income less than the entire earning is subject to scrutiny.¹⁸⁹

Keller received less income from the corporation than he had

¹⁸²*Id.* at 4189.

¹⁸³*Id.* at 4191.

¹⁸⁴*Id.* at 4191-92.

¹⁸⁵*Id.* at 4192.

¹⁸⁶*See id.* at 4197 n.15.

¹⁸⁷*Id.* at 4191.

¹⁸⁸*Id.*

¹⁸⁹*Id.*

previously received as a sole practitioner *or* than he would have received absent incorporation. The Tax Court, nonetheless, found that his total compensation was "substantially proximate" to the figures he had received or would have received without the corporate structure.¹⁹⁰ The court relied on the "significant additional value to petitioner in any pension contributions as opposed to an outright salary"¹⁹¹ to reach this conclusion. Recognizing that Keller's *taxable* income had been significantly reduced by incorporation, the court noted that the result was specifically provided by code sections which authorize income nonrecognition or deferral.¹⁹² The use of the corporate form to manipulate income, thus, was not deemed to be problematic in this situation.

In making this decision, the court has changed the impact of section 482. The primary concern remains the distortion of income as determined by the arm's length transaction test and the employee-shareholder must still receive "essentially [the] equivalent" to the amount receivable absent incorporation, but the court has indicated that the *form* of that receipt is not necessarily a *limitation* if the form is one of which Congress approves for the corporate status. Furthermore, the form of the income may be a beneficial factor, as in *Keller*, if it provides "significant additional value."

This aspect of *Keller v. Commissioner* makes two important statements about the personal service corporation and section 482. First, to the extent that corporate benefit plans are authorized and encouraged by Congress, section 482 will not be used to interfere with the advantages afforded. Second and implied from the first, section 482 will allow recognition of the "corporateness" of the personal service corporation and will permit the benefits which accompany corporate status to inure.

¹⁹⁰*Id.* at 4192.

¹⁹¹*Id.* at 4193.

¹⁹²*Id.* The *Achiro* court noted the same idea as it compared the benefits available to the self-employed person with those available through the corporate form.

It is well-known that operating a business in corporate form provides advantages not available to self-employed individuals. In recent years, however, the driving force behind an ever increasing use (particularly by professionals) of corporations is the advantage of the richer tax deferral obtained through establishment of a corporate retirement plan. For example, for taxable years beginning before 1982, an employee not otherwise covered by a retirement plan is limited to the use of an Individual Retirement Account which permits qualified contributions not in excess of 15 percent of compensation or \$1,500, whichever is less. Sec. 219. Also for taxable years beginning before 1982, the tax deferred contribution available to a self-employed individual under a Keogh Plan (also known as H.R. 10 plan) is limited to the lesser of \$7,500 per year or 15 percent of earned income. Sec. 404(e)(1). For taxable years beginning after 1981, however, even active participants in

This conclusion is not negated by the *Foglesong v. Commissioner*¹⁹³ decision on remand. In this case, the Tax Court reached the same conclusion that had resulted the first time, although section 482 was used in lieu of the assignment of income doctrine.¹⁹⁴ Part of the 98% of the corporate income that was allotted to Foglesong represented a dividend distribution to the preferred shareholders.¹⁹⁵ Read broadly, this aspect of *Foglesong* would appear to deny the "corporateness" of the corporation by denying the propriety of corporate dividends by a personal service corporation and by taxing this distributed amount to Foglesong instead of to the corporation. Innocence, however, was not the hallmark of the dividend declaration and the court's reaction implied that the corporate form should not be used to achieve certain tax manipulations.¹⁹⁶ The funnelling of \$38,000 to Foglesong's children as dividends on stock for which the subscription cost of \$400 was paid by Foglesong himself represented one such transaction.

The *Foglesong* court, furthermore, explicitly noted its reaffirmation of the concepts that it laid down in *Achiro* and *Keller*.

employer-sponsored plans may contribute to an Individual Retirement Account. Additionally, the maximum amount of a qualified contribution to an Individual Retirement Account is increased to the lesser of \$2,000 or 100 percent of compensation. The Economic Recovery Act of 1981, Pub. L. No. 97-34, section 311, 95 Stat. 274-283 (1981). Similarly for taxable years beginning after 1981, the maximum contribution to a Keogh Plan is increased to the lesser of \$15,000 or 15 percent of income, and the amount of income that can be taken into account when computing the deduction is increased from \$100,000 to \$200,000. The Economic Recovery Act of 1981, Pub. L. No. 97-34, section 312, 95 Stat. 283-285 (1981).

In contrast, under a qualified pension or profit-sharing plan a corporate employee-shareholder can enjoy annual contributions on his behalf to defined contribution plans in an amount not exceeding \$41,500. Sec. 415(c)(1)(A); I.R.S. News Release 81-16, February 4, 1981. Alternatively, under a qualified defined benefit pension plan the maximum contribution is an amount that will provide him with an annuity of \$124,500 or an annuity equal to his average compensation for his most remunerative three consecutive years. Sec. 415(b)(1); I.R.S. News Release 81-16, February 4, 1981. The corporate employee can also have a combination of benefits through contributions to both defined contribution plans and defined benefit plans subject to the rule of 1.4. Section 415(e).

[1981 Transfer Binder] TAX CT. REP. (CCH) at 4097 (footnotes omitted).

¹⁹³[1981 Transfer Binder] TAX CT. REP. (CCH) at 4245.

¹⁹⁴*Id.* at 4247.

¹⁹⁵See notes 156-57 *supra* and accompanying text.

¹⁹⁶[1981 Transfer Binder] TAX CT. REP. (CCH) at 4247. The court noted that, although the petitioner had some valid reasons for incorporating, the primary reason was to avoid taxes. Because of the inclusion of legitimate reasons, the corporation would not be ignored, but the Service was not obligated to approve *any* allocation of income that the two entities might decide feasible. *Id.*

It is important to note at this juncture that it is not our intention to discourage the use of the corporate form for personal service businesses where one of the purposes of incorporation is to take advantage of certain intended Federal tax law benefits, i.e., medical reimbursement plans, death benefits, and retirement plans. . . . Clearly Congress has intended such a use of the corporate form, and it would be inappropriate for us to adopt a rule to the contrary.¹⁹⁷

Section 482, therefore, has been used to recognize the personal service corporation as a viable corporate entity with the advantages and disadvantages that accompany the status.

B. Form and Formalities

Keller v. Commissioner also involved certain implications about the use of the closely-held personal service corporation within the framework and structure of other legally recognized entities and about the effectiveness of meticulous compliance with corporate formalities.¹⁹⁸ These implications inspired the wrath of the dissenters.¹⁹⁹ The *Keller* dissent seemed to forecast the death of the assignment of income doctrine in relation to the personal service corporations and to lament its replacement by such an ineffective tool as section 482.²⁰⁰

As previously noted, Keller, a pathologist, was a general partner of a partnership known as Medical Arts Laboratory (MAL). MAL provided only pathology services and received its laboratory and technical assistance from Medical Arts Laboratory, Inc. (MAL, Inc.), of which the MAL partners were directors and shareholders. MAL had no equipment, supplies, or medical personnel. MAL paid MAL, Inc. for the technical and laboratory services provided and the MAL partners provided supervisory assistance to MAL, Inc. for a salary. Thus, Keller received his share of partnership income and income from MAL, Inc. for his supervisory role.

In 1973, Keller formed Dan F. Keller, M.D., Inc. (Keller, Inc.), became the sole shareholder, and was elected president-treasurer with his wife serving as secretary. By written agreement with

¹⁹⁷*Id.* (citing *Keller v. Commissioner*, [1981 Transfer Binder] TAX CT. REP. (CCH) at 4183 and *Achiro v. Commissioner*, [1981 Transfer Binder] TAX CT. REP. (CCH) at 4089).

¹⁹⁸See notes 202-03, 219-22 *infra* and accompanying text.

¹⁹⁹[1981 Transfer Binder] TAX CT. REP. (CCH) at 4198 (Wilbur, J., dissenting).

²⁰⁰*Id.* at 4205 n.11. A footnote clearly expressed this concern: "And plainly we will sooner or later be confronted with arrangements between professionals and corporations for which sec. 482 will be inadequate, and the decision today to so lightly discard the assignment of income doctrine will come home to roost." *Id.*

MAL, Keller, and the new corporation, Keller, Inc., was substituted for Keller as general partner, although Keller promised to guarantee Keller, Inc.'s obligations to the partnership. A similar agreement with MAL, Inc. was not made until over a year later. Additionally, an employment contract was executed between Keller and Keller, Inc. Bank accounts were opened. The name was changed on the door of the MAL facility and on the letterhead. Accounting books were maintained. All necessary forms and applications were filed with the Internal Revenue Service and the State of Oklahoma.

1. *Formalities.*—The Tax Court was obviously impressed with the “[s]ubstantial care . . . taken to observe the requisite corporate formalities . . . including the execution of an employment agreement”²⁰¹ Finding no fault with the corporation formation, the court concluded that the personal service corporation was organized as a corporation under state law and met the requirement for recognition as a corporation under Revenue Ruling 70-101.²⁰²

As previously noted, the court found section 482 to be applicable. In reaching this conclusion, however, the court appeared to take the step predicted by commentators²⁰³ and stated that employee status was sufficient to meet the dual business requirement of the Code section.²⁰⁴

Once the court found a valid corporation and no distortion of income under section 482,²⁰⁵ any argument posed by the Service, such as assignment of income, lack of corporate property or other employees, was labelled as an attempt to nullify the corporate existence.²⁰⁶ The court apparently saw adequate protections within the definition of corporation and the safeguards of section 482 to conclude that once these hurdles had been overcome, all further arguments concerning income distribution would negate a prior conclusion²⁰⁷ or

²⁰¹*Id.* at 4188.

²⁰²*Id.*

²⁰³See notes 137-38 *supra* and accompanying text.

²⁰⁴[1981 Transfer Binder] TAX CT. REP. (CCH) at 4190. The court noted that the business of the medical practice was operated on two levels, the corporate level and the employee level. The court further stated that “the corporation employs petitioner to perform the requisite services. Petitioner, in turn, is in the *business* of providing services as an employee of his wholly owned corporation.” *Id.* (emphasis added). To support this extension, the court cited *Primuth v. Commissioner*, 54 T.C. 374 (1970), as holding that an employee is in a trade or business for the purposes of section 162. *Id.*

This aspect of the case was reiterated in *Foglesong v. Commissioner*, [1981 Transfer Binder] TAX CT. REP. (CCH) at 4247, when the court stated: “Because the petitioner as an employee and the corporation are separate taxable entities and separate trades or businesses, we hold . . . the threshold requirement of section 482, . . . is met.” *Id.* (footnote omitted) (emphasis added).

²⁰⁵See note 190 *supra* and accompanying text.

²⁰⁶[1981 Transfer Binder] TAX CT. REP. (CCH) at 4194.

²⁰⁷*Id.* For example, the court recognized that attempts to shift all the income from

were redundant.²⁰⁸ Indeed, the court found that the result of applying the assignment of income doctrine would have been the same as using section 482.²⁰⁹

The majority, thus, has added strength to the corporate recognition of the personal service corporation and has reinforced the necessity of careful compliance with the formalities of state and federal law to achieve this desired result.

The dissent was dismayed. It found this situation very similar to *Roubik v. Commissioner*²¹⁰ where the court relied on the assignment of income doctrine to tax the employees.²¹¹ The facts, nevertheless, have often been cited to exemplify a sham corporation.²¹² Like *Roubik*, the dissent noted that Keller, Inc. owned no equipment, incurred no debts, paid no salaries except Keller's and maintained no medical records.²¹³ Virtually all control was in the partnership and all equipment and support resources were in MAL, Inc. To the dissent, therefore, the unavoidable conclusion was that "Keller, Inc. was 'nothing more than a few incorporating papers lying in a desk drawer of no significance except when a tax return is due.'"²¹⁴ Given the general lack of substance, the dissent argued that the scheme was merely an assignment of income from Keller to his corporation and that it would have used the doctrine to tax Keller on *all* corporate receipts.²¹⁵ The dissenting opinion was in complete disagreement with the majority opinion as to the impact of the assignment of income doctrine in this case.²¹⁶ It noted with apprehension that the

the corporation to Keller under any theory would effectively nullify the prior conferral of corporate status. *Id.*

²⁰⁸*Id.* at 4195.

²⁰⁹*Id.*

²¹⁰53 T.C. 365 (1969).

²¹¹See note 54 *supra* and accompanying text.

²¹²See notes 54-56 *supra* and accompanying text.

²¹³[1981 Transfer Binder] TAX CT. REP. (CCH) at 4199.

²¹⁴*Id.* at 4200 (quoting *Foglesong v. Commissioner*, 621 F.2d 865, 873 (7th Cir. 1980) (Wood, J., dissenting)).

²¹⁵[1981 Transfer Binder] TAX CT. REP. (CCH) at 4203.

²¹⁶*Id.* at 4205. In a rather pointed footnote, the dissent clearly asserted its view of the majority's conclusion.

The majority tells us (surely with tongue in cheek) that "The net effect of applying the assignment of income principles, thus, is the same, in this case, as applying section 482: petitioner is not directly taxable on all the income received by Keller, Inc." Since, if the assignment of income doctrine applies, precisely the opposite is true—petitioner will be directly taxed on all the income—this statement is patently false. And obviously for many reasons the results are not the same, but dramatically different, and that is what this case is all about.

Id. at 4205 n.10.

majority was willing to recognize the apparent grant of immunity against this doctrine when section 482 was deemed applicable.²¹⁷

The dissent provides some helpful insights to the probable impact of the *Keller* decision. The dissent reads the majority as striking the final death blow to the assignment of income doctrine.²¹⁸ The dissent, in addition, notes the shift in focus from substance to form to formalities.²¹⁹ Although compliance with formalities has always been significant to the courts,²²⁰ and the failure to follow requisite formalities has often been used to justify the imposition of additional tax under one of the common law doctrines,²²¹ formality now seems to be the only concern which permits the court to maintain the corporate integrity of the personal service corporation.²²²

Meticulous compliance with the requirements in state corporate organizational statutes, therefore, is more important than ever for the personal service corporation as is the strictest respect for the entity once it is created. This undue concern for detail may be sufficient to earn the label of corporation, which will not provide exemption from section 482 but will safeguard the personal service corporation from the dangers of the common law doctrines.

2. *The Use of the Personal Service Corporation within the Framework of Other Entities.*—The *Keller* decision showed little concern for the complexity or uniqueness of the arrangements. No increase in suspicion or scrutiny was apparently required because of the use of the personal service corporation within the structure of other lawful entities. Keller, Inc. had complied with the requirements of state and federal laws; contracts with the other entities had been executed. The personal service corporation had been respected, but the structure within which the corporation operated had seemingly no significance.

The dissent was appalled at the total arrangement. Noting with distaste the artificial division of the pathology practice itself, the dissent found that "[t]he addition of petitioner's corporation is one slice too many, tissue paper thin, without functional reality or economic substance."²²³ To fully demonstrate the problems posed by

²¹⁷*Id.* at 4203.

²¹⁸See note 200 *supra*.

²¹⁹[1981 Transfer Binder] TAX CT. REP. (CCH) at 4200. Noting that, even if Keller had carefully followed formality, Keller, Inc. was no more than an "incorporated pocketbook," the dissenting opinion bemoaned that "attenuated subtleties triumph over economic substance and practical reality, and form and artifice reclaim center stage of our tax laws." *Id.*

²²⁰See, e.g., note 145 *supra* and accompanying text.

²²¹See, e.g., notes 54-56, 97 *supra* and accompanying text.

²²²[1981 Transfer Binder] TAX CT. REP. (CCH) at 4194-95.

²²³*Id.* at 4199.

allowing this type of "contrived" structure, the dissenting opinion took the arrangement to its logical extreme, asserting that all the partners of MAL and all the employees of MAL, Inc. could incorporate and adopt benefit plans to fit individual needs without concern for the needs of other employees.²²⁴ As the scenario was unfolded, however, the obvious concern of the dissent became apparent: the potentiality for abuse of benefit plans and avoidance of the nondiscrimination provisions.²²⁵

The dissent further noted that this corporation was not the type of entity which the Service had intended to fall within the definition of corporation under Revenue Ruling 70-101.²²⁶ Because of the structure within which the personal service corporation existed, the corporation had virtually no control over the activities of its principal employee because most of these decisions were made at the partnership level.²²⁷ With no control and with no equipment, facilities or employees, the corporation simply served no legitimate function except to funnel funds of the "employee" to the corporation;²²⁸ this conduit role certainly did not produce the needed legitimacy. The dissent, therefore, concluded that the assignment of income doctrine was the appropriate tool to remedy the problems created by this complex arrangement.²²⁹

Again, the dissent's fears highlight the true impact of the case. The assignment of income doctrine has *no* place in the personal service context as long as even minimum respect is given to the corporate entity.²³⁰ Section 482 will always apply to these corporations and the

²²⁴*Id.* at 4200-01. After asserting that each partner could incorporate, the dissent painted a verbal picture of the resulting confusion.

We would have MAL, Inc., at the center surrounded by the partnership and eleven corporate arms extending out in different directions, each a hollow prosthetic device without offices, a laboratory, equipment, facilities, employees, medical records, or any other items normally used in the practice of pathology. The sole function of this paper octopus would be to serve as an incorporated pocketbook, enabling each physician to have a pension plan and fringe benefit package tailored to his own preferences without regard to the quite different preferences of each of his partners and whether or not the employees of the business were provided anything at all.

Id. (footnote omitted).

²²⁵*Id.* The dissent seemed concerned with the possibility of manipulations found in *Achiro*. See notes 171-72, 176-78 *supra* and accompanying text.

²²⁶[1981 Transfer Binder] TAX CT. REP. (CCH) at 4201. The dissent argued that the ruling had intended to benefit the incorporation of a professional business, complete with assets, equipment, facilities, personnel and other attendants commonly associated with the practice of a profession. *Id.*

²²⁷*Id.* at 4199-201.

²²⁸*Id.* at 4201.

²²⁹*Id.* at 4201-03.

²³⁰See note 200 *supra*.

shareholder-employee(s).²³¹ While these ideas epitomize the *Rubin* and *Foglesong* reasoning, neither *Keller* nor *Achiro* are appealable to the Second or Seventh Circuit Court of Appeals.²³²

Benefit plans, additionally, are a valid corporate entitlement and may be the sole reason for incorporating. The majority suggested that the desire for qualified benefits, only available through the use of the corporate form, may constitute a business purpose under the *Moline Properties* test.²³³ If not, the corporation must carry on a business.²³⁴ As the dissent has indicated,²³⁵ however, this must be a very low threshold requirement if *Keller, Inc.* met the criteria.²³⁶

The dissent also noted with displeasure that the sole corporate employee was able to have a tailored benefit plan without concern for the needs of the other employees in other levels of the structure. The majority, however, almost encouraged such use of the corporate form.²³⁸ Apparently, the majority found the reasoning of *Achiro* to be persuasive, although this was not explicitly developed in the opinion. If the use of the corporate form to gain qualified benefits which, in effect, discriminate against employees in another part of the "structure" is the "evil" to be corrected, section 482, the assignment of income doctrine, and other judicially-created principles used to reallocate income are simply not the appropriate tools.²³⁹ If there are loopholes in the code that allow these inequities to occur, then Congress needs to close them. Section 482, however, should not be stretched beyond recognition to remedy this situation.

If the personal service corporation is authorized under state law to serve as a partner or in any other capacity needed to create a superstructure,²⁴⁰ then the complexity of the arrangement is not problematic when the corporate identity is respected. Seemingly, it is unnecessary for the corporation to establish all policy or to maintain strict control over the activities of its employee(s) if the corporation has sufficient input into the decisions of the controlling body.²⁴¹ In *Keller*, the corporation acted as a general partner and

²³¹See note 204 *supra* and accompanying text.

²³²*Achiro v. Commissioner* is appealable to the Ninth Circuit and *Keller v. Commissioner* is appealable to the Tenth Circuit.

²³³[1981 Transfer Binder] TAX CT. REP. (CCH) at 4193-94.

²³⁴*Id.* See also note 51 *supra* and accompanying text.

²³⁵[1981 Transfer Binder] TAX CT. REP. (CCH) at 4202-03.

²³⁶*Id.* at 4193-94.

²³⁷See note 224 *supra*.

²³⁸See [1981 Transfer Binder] TAX CT. REP. (CCH) at 4193-94.

²³⁹See notes 176-78 *supra* and accompanying text.

²⁴⁰The capacity question was not raised in *Keller*. [1981 Transfer Binder] TAX CT. REP. (CCH) at 4196 n.1a.

²⁴¹The dissent pointed out the control of the partnership: "The partnership

exerted as much influence as any other partner.²⁴²

These cases indicate that the personal service corporation has, at long last, been given its fitting title of *corporation*. With the title comes all the advantages and disadvantages of the status. Abuses resulting from the special nature of this corporation are still subject to the sanction of reallocation under section 482.²⁴³

C. Impact on Planning

Keller, *Achiro*, and *Foglesong* have indicated a new understanding and appreciation for the personal service corporation through the vehicle of section 482. These cases also provide useful insights for the tax planner who wants to avoid the dangers common in this context. The following should serve as a checklist for preventing or at least reducing the likelihood of reallocation.

1. *The Definition of Corporation*.—The first major hurdle to avoid all Service arguments for reallocation is to meet the criteria for attaining the "corporate" label. This includes careful, complete compliance with state law, both as to organization and ongoing operation.²⁴⁴ Although the state label does not necessarily require corporate recognition for federal tax purposes,²⁴⁵ nonetheless the state status adds weight under Revenue Ruling 70-101 for the corporation being "organized and operated as a corporation" and facilitates the conclusion that it should "be classified as such."²⁴⁶

2. *Employment Contracts*.—One of the most frequently cited instances demonstrating lack of corporate respect and of corporate control is the failure to execute an employment contract with a covenant not to compete.²⁴⁷ If the covenant is not included, the shareholder-employee must provide his services exclusively for the corporation to avoid an argument that the corporation had no control over the activities of its employee.²⁴⁸

Once the employment relationship is created with the accompa-

establishes every essential element of the business—from fees charged and customers served to the division of the income among the eleven partners in accordance with the partnership agreement." *Id.* at 4199. However, it seemingly found no significance in the fact that the corporation, through its sole agent, exercised some control.

²⁴²*Id.* at 4185.

²⁴³*See, e.g., Foglesong v. Commissioner*, [1981 Transfer Binder] TAX CT. REP. (CCH) No. 38,423, at 4245.

²⁴⁴*See* notes 201-02 *supra* and accompanying text.

²⁴⁵*See, e.g., Burnet v. Harmel*, 287 U.S. 103, 110 (1932).

²⁴⁶Rev. Rul. 70-101, 1970-1 C.B. 278, 280.

²⁴⁷*See Burdett, supra* note 26, at 336.

²⁴⁸In *Keller*, the majority refused to grant unreasonable weight to the fact that the employment contract did not include a covenant not to compete. [1981 Transfer Binder] TAX CT. REP. (CCH) at 4194-95.

nying agency relationship, the Service's argument that the corporation failed to conduct business is difficult to maintain, even against the one-person personal service corporation. This was noted by the *Keller* court: "Certainly petitioner performed the only services for which Keller, Inc. was compensated, but it is axiomatic that a corporation can only perform services through its agents, whether it be a one-man corporation or an international conglomerate."²⁴⁹

Although execution of an employment contract may seem like a meaningless formality in light of the realities of the personal service corporation, the benefits of compliance certainly outweigh the minor inconvenience.

3. *Contracts for Rendition of Services.*—Related to the employment agreement requirement, and equally important, the corporation must be substituted for the "now-employee" on all service contracts that may have existed prior to incorporation.²⁵⁰ While the court may find a novation if the parties have been informed,²⁵¹ the more likely response of the Tax Court is to have all income earned before the contract revision taxed to the employee.²⁵² Likewise, this result is not circumvented simply by having the *corporate name* substituted for the employee's on payment checks.²⁵³ Immediately after formation of the corporation, therefore, the new corporation must make new agreements with the service recipients for the services of the shareholder-employee(s).

4. *Salary and Benefits.*—In calculating the value of the employee's total compensation package, the corporation must be guided by the arm's length test, the measuring stick of section 482.²⁵⁴ The test itself, unfortunately, does not provide much concrete guidance, but because the court would consider the employee's compensation prior to incorporation and the compensation potential absent incorporation,²⁵⁵ these represent important considerations for the corporation to use as well. The total compensation, however, does not need to be salary, but may also include benefit plans.²⁵⁶ If

²⁴⁹*Id.* at 4195.

²⁵⁰*Keller* did this with the partnership immediately, but failed to bring about the change with the corporation, MAL, Inc., for over a year. *Id.* at 4186.

²⁵¹The Tax Court found a novation in *Foglesong v. Commissioner*, 35 T.C.M. (CCH) 1309, 1315 (1976).

²⁵²[1981 Transfer Binder] TAX CT. REP. (CCH) at 4183.

²⁵³This ploy proved ineffective in *Keller*. Although no formal agreement was made between MAL, Inc. and Keller, Inc., Keller convinced MAL, Inc. to substitute Keller, Inc. for Keller on the checks. *Id.* at 4186. The court was not deceived and the income earned from MAL, Inc. prior to a formal contract was taxable to Keller individually. *Id.* at 4192.

²⁵⁴See notes 187-89 *supra* and accompanying text.

²⁵⁵[1981 Transfer Binder] TAX CT. REP. (CCH) at 4183.

²⁵⁶See notes 183-86, 190-92 *supra* and accompanying text.

the benefit plans are qualified, the corporation may acknowledge that this has reduced the employee's taxable income and, therefore, has provided "significant additional value" in this form as compared to salary form.²⁵⁷

Once compensation terms have been reached, payment should be made at regular intervals.²⁵⁸ Having the corporation withhold payments for a few months may provide tax advantages to the employee, but it is also a sign of lack of corporate control and an indication of a non-arm's length transaction.²⁵⁹ This manipulation results in reallocation of withheld income under section 482. The desired tax benefit, therefore, is not obtained.²⁶⁰ Having displayed such a cavalier regard for the corporate entity, the employee also may be subject to greater suspicion by the court on other aspects of the income split.

The concerns of the court in cases like *Keller*, therefore, must be the concerns of the personal service corporation in fixing the salary and fringe benefits of its employees. Moreover, careful attention must be given so that regularity is the hallmark of employee salary payments.

These four areas represent the major obstacles faced by the personal service corporation under section 482. Care in these areas should also prevent the court from allowing the Service to seriously mount arguments under the assignment of income doctrine.²⁶¹ The use of the personal service corporation within the context of complex structure should not alter the section 482 analysis. The complexities, however, may create problems with the nondiscrimination requirements for qualified benefit plans.²⁶² Problems posed by these benefit plans, nevertheless, are not problems to be alleviated by section 482.²⁶³

A thorough understanding of section 482 and a sensitivity to its purpose and provisions during the planning stages of the personal service corporation should reduce conflicts and disagreements with the Commissioner and the Service at later points.

²⁵⁷See note 186 *supra* and accompanying text.

²⁵⁸See, e.g., *Foglesong v. Commissioner*, 35 T.C.M. (CCH) 1309 (1976), *rev'd and remanded*, 621 F.2d 865 (7th Cir. 1980), *on remand*, [1981 Transfer Binder] TAX CT. REP. (CCH) No. 38,423, at 4245.

²⁵⁹*Foglesong v. Commissioner*, 35 T.C.M. (CCH) at 1313-14 (assignment of income doctrine used to tax earnings to "employee").

²⁶⁰*Foglesong v. Commissioner*, [1981 Transfer Binder] TAX CT. REP. (CCH) at 4246-48 (same result using section 482).

²⁶¹See notes 209-12 *supra* and accompanying text.

²⁶²*Keller v. Commissioner*, [1981 Transfer Binder] TAX CT. REP. (CCH) at 4197 n.4 (Wilbur, J., dissenting).

²⁶³See notes 176-78, 239 *supra* and accompanying text.

V. CONCLUSION

Because employee status is now sufficient to constitute a trade or business under section 482,²⁶⁴ the dual business requirement poses no barrier to the application of section 482 to the personal service corporation. Although this dreaded expectation has become reality,²⁶⁵ this does not require the acknowledgement of a sound defeat and the clamoring to surrender. In fact, the personal service corporation may claim minor victories and rejoice at the demise of the assignment of income doctrine in this battlefield and at the long awaited recognition of its existence as a viable entity.

Section 482 provides a mechanism to carefully balance the special nature of the personal service corporation and the policies underlying the graduated income tax.²⁶⁶ Some income manipulations, like qualified benefit plans, have received the blessing of Congress. Section 482 recognizes that to deny these corporate advantages is to deny corporate status. These manipulations are permitted, and even encouraged. Other income manipulations, however, exist only because control of the personal service corporation is, by its very nature, held by the shareholder-employee. Section 482 notes that such unlimited control does not usually exist in the corporate structure; hence, to limit the control does not prove fatal to the corporate entity. Unbounded control in an employee is simply not a common corporate characteristic.

Full recognition of corporate status requires the personal service corporation to bear both the advantages and disadvantages that attach to the corporate label. Therefore, to put the personal service corporation and its employee, on an equal tax footing with the typical corporation and its employees, section 482 reallocates income based on the standard of arm's length transactions.

Unlike the common result using the assignment of income doctrine, reallocation under section 482 can be accomplished with less sweeping measures than total income allocation to the employee. Additionally, the advantages of fringe benefit plans are an appropriate consideration.

Section 482 accomplishes its intended purpose without providing actual advantages to either the Service or the personal service corporation. It provides the Service with a tool to reallocate income that has resulted from taking undue advantage of the unique nature of the entity. At the same time, it allows the corporation to be a

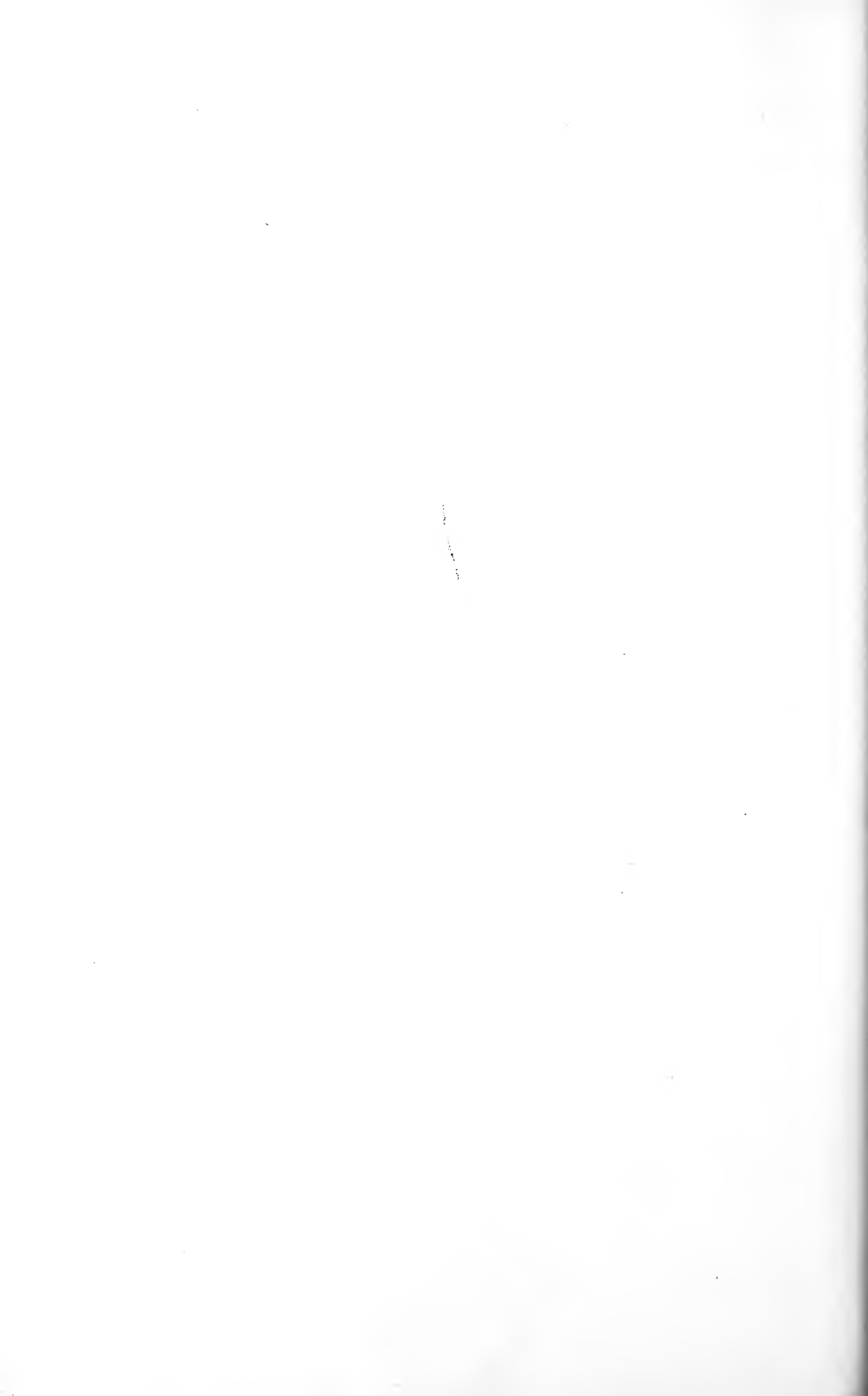
²⁶⁴Foglesong v. Commissioner, [1981 Transfer Binder] TAX CT. REP. (CCH) at 4247; Keller v. Commissioner, [1981 Transfer Binder] TAX CT. REP. (CCH) at 4189.

²⁶⁵See notes 139, 148-49 *supra* and accompanying text.

²⁶⁶See note 12 *supra*.

corporation with all the benefits and detriments of that status.

Perhaps this use of section 482 has only effectively changed the battlefield with little impact on ending the war. If nothing else, however, it has helped to even the odds.



Notes

The Causation Problem in Asbestos Litigation: Is There an Alternative Theory of Liability?

I. INTRODUCTION

"Asbestos" is the name given to a family of hydrated silicate minerals which occur naturally as masses of fibers with the unique properties of relative indestructibility and high resistance to fire.¹ These properties combine to make asbestos an invaluable ingredient in a variety of products used to protect human life.²

Ironically, asbestos has recently been labeled one of the most dangerous and life-threatening natural materials used by man.³ Masses of asbestos fibers, when disturbed in any manner, have a tendency to break easily into tiny dust particles which become suspended in the air.⁴ Extended periods of ingestion and inhalation of these particles have recently been linked to such debilitating diseases as asbestosis,⁵ bronchogenic carcinoma,⁶ and mesothe-

¹Mansfield, *Asbestos: The Cases and the Insurance Problem*, 15 FORUM 860 (1980); Mehaffy, *Asbestos-Related Lung Disease*, 16 FORUM 341, 341-42 (1980).

²The heat-resistant properties and fibrous structure of asbestos make it extremely desirable as a fireproofing, insulating, and friction-resistant material. These unique properties make it a valuable ingredient in such products as brake shoes on automobiles, fireproof clothing, fire-resistant wallboard and cement, and coverings for pipes and electrical wiring. See U.S. DEP'T OF HEALTH, EDUC., AND WELFARE, PUB. L. No. 78-1594, ASBESTOS EXPOSURE (1978) [hereinafter cited as DHEW ASBESTOS EXPOSURE].

³Mehaffy, *supra* note 1, at 341.

⁴DHEW ASBESTOS EXPOSURE, *supra* note 2, at 1.

⁵Asbestosis is classified as a pneumoconiosis (lung disease caused by extended inhalation of a mineral or metallic dust). It is a nonmalignant response of the body to the inhalation of asbestos fibers which sets up an inflammatory process that replaces functioning lung tissue with scarred tissue. This process destroys the air sacs in the lung tissue, preventing the lung from diffusing oxygenated blood to the arteries and preventing carbon dioxide from being released. There are two types of asbestosis; parenchymal asbestosis and pleural asbestosis. These two types of asbestosis may occur simultaneously or independently. Each can be severely disabling and neither type is necessarily fatal. Currently, there is no cure for asbestosis. Also, asbestosis is generally accompanied by an enlargement of the right side of the heart (cor pulmonale) resulting from the encroachment of the scar tissue on the lung. Essentially, the heart must work harder to deliver oxygenated blood to the body, causing the right side enlargement. Deposition of Harriet Louise Hardy, M.D. at 18-23, *Roderman v. Combustion Eng'r, Inc.*, No. C72-390 (N.D. Ohio, deposition taken on Feb. 21, 1977) [hereinafter cited as Deposition of Dr. Hardy].

⁶Bronchogenic carcinoma of the lung, as characteristic of most cancers, involves

lioma.⁷ Each of these diseases has a documented latency period of twenty to forty years after the initial exposure to asbestos.⁸

The recent proliferation of product liability lawsuits for asbestos-related diseases had its genesis in the 1973 case of *Borel v. Fibreboard Paper Products Corp.*⁹ Between 1973 and 1980, an estimated ten thousand asbestos suits were filed.¹⁰ As of February 1, 1981, twenty-five thousand individual plaintiffs had filed asbestos suits with an additional five hundred suits being filed each month.¹¹ This, however, is only the beginning. An estimated eleven million American workers have been exposed to significant concentrations of asbestos since the beginning of World War II,¹² and this does not begin to include the millions of consumer exposures.¹³ Appropriately,

the completely disordered multiplication of cells in the lung and bronchial tubes resulting in the unrestrained growth of abnormal cells. These abnormal cells tend to break into bits and be distributed to other parts of the body via the blood stream or lymphatic system where the unrestrained growth and multiplication continues. For instance, if one of these abnormal cells is carried to the brain, an individual may experience what appears to be a stroke. Bronchogenic carcinoma is ultimately fatal. *Id.* at 23-28.

⁷Mesothelioma is a diffuse malignancy of the mesothelial cells which are found in various linings of the body, such as the pleura (thoracic cavity lining) and the peritoneum (abdominal cavity lining). These linings react to the inhalation or ingestion of asbestos fibers resulting in the very rapid multiplication of cells. This multiplication of cells, referred to as a tumor, eventually presses against the lungs, impairing breathing. There is no known cure for mesothelioma and it is fatal in all cases. *Id.* at 28-31.

⁸In some cases, these diseases may become manifested to the point of diagnosis within two months after the initial exposure. Generally, however, the latency period is over twenty years after first exposure. *Id.* at 26-27; Henderson, *Product Liability Disease Litigation: Blueprint for Occupational Safety and Health*, TRIAL, April 1980, at 26; see also note 12 *infra*. This latency period is explained by the fact that asbestos fibers, once inhaled, remain in place in the lung, causing a tissue reaction that is slowly progressive and apparently irreversible. Even if no additional fibers are inhaled, tissue damage may continue undetected for decades. Furthermore, the effect of the disease is cumulative because each exposure to asbestos dust can result in additional tissue damage. See generally Comment, *Asbestos Litigation: The Dust Has Yet To Settle*, 7 FORDHAM URB. L.J. 55, 63 (1978) [hereinafter cited as *Asbestos Comment*].

⁹493 F.2d 1076 (5th Cir. 1973), *cert. denied*, 419 U.S. 869 (1974). The first asbestos case, *Potter v. Fibreboard Paper Prod. Corp.*, No. C.A.6329 (E.D. Tex. 1968), was filed in 1968 and settled for a relatively small amount prior to verdict. *Borel* was the first asbestos case which was tried to a verdict.

¹⁰Mehaffy, *supra* note 1, at 345.

¹¹Levit, *Levit Outlines Catastrophic Product Liability Development*, Nat'l Underwriter, June 19, 1981, at 20, col. 1.

¹²DHEW ASBESTOS EXPOSURE, *supra* note 2, at 2; Mansfield, *supra* note 1, at 865-66.

¹³The carcinogenic effects of consumer products are speculative because little research of this type has been done. The sale of certain items containing asbestos, however, has been banned. 42 Fed. Reg. 63,354-64 (1977). For instance, in 1978, the Consumer Product Safety Commission issued a two-page fact sheet encouraging homeowners to remove asbestos-containing patching plaster, and to remove and

the effects associated with asbestos exposure have been labeled "toxic time bombs."¹⁴

Asbestos litigation presents unique legal problems.¹⁵ A major problem is the inherent difficulty in identifying the manufacturer of the particular products which caused the plaintiff's injuries. Due to the latency period of asbestos diseases, the plaintiff and his co-workers' memories concerning the particular products they used are often faulty. In many cases, documents which identify the products used have been lost or destroyed.¹⁶ Furthermore, because workers may have moved from one job to another, and because the employers using asbestos products generally obtain them from more than one manufacturer, the asbestos plaintiff has frequently been exposed to thousands of products containing asbestos. Where the asbestos plaintiff was a bystander,¹⁷ consumer, or demolition worker,¹⁸ the difficulties associated with the identification of the product and the manufacturer of that product become even more pronounced.

Traditionally, identification of the manufacturer has been a recognized requirement in product liability actions.¹⁹ For example, under the Indiana Product Liability Statute which codifies the common law action of strict liability, the defendant must be linked in some way to the defective and unreasonably dangerous product which caused the injury before that defendant may be held liable.²⁰ This requirement may prevent recovery for many plaintiffs in asbestos lawsuits, where manufacturer identification is not always

dispose of any asbestos-containing artificial fireplace logs which were being used in conjunction with gas burners in fireplaces. U.S. DEPT OF HEALTH, EDUC., AND WELFARE, PUB. L. NO. 78-1842, ASBESTOS AND HEALTH: AN ANNOTATED BIBLIOGRAPHY OF PUBLIC AND PROFESSIONAL EDUCATION MATERIALS 4 (1978).

¹⁴Podgers, *Toxic Time Bombs*, 67 A.B.A. J. 139 (Feb. 1981).

¹⁵One problem for individuals injured as a result of asbestos exposure is the application of a statute of limitations. See, e.g., *Bassham v. Owens-Corning Fiber Glass Corp.*, 327 F.Supp. 1007 (D.N.M. 1971). But see, e.g., *White v. Johns-Manville Corp.*, 662 F.2d 234 (4th Cir. 1981); *Bunker v. National Gypsum Co.*, 426 N.E.2d 422 (Ind. Ct. App. 1981). Another unique problem in this litigation involves insurance coverage. See, e.g., *Keene Corp. v. Insurance Co. of N. Am.*, No. 81-1180 (D.C. Cir. 1981); *Insurance Co. of N. Am. v. Forty-Eight Insulations Inc.*, 633 F.2d 1212 (6th Cir. 1980).

¹⁶Henderson, *supra* note 8, at 26.

¹⁷For the purposes of this Note, a bystander is a worker who did not work directly with asbestos products, but was working in close proximity with workers using asbestos products so as to be exposed to similar concentrations of asbestos dust.

¹⁸A demolition worker may be exposed to high concentrations of asbestos dust during the demolition of a building which contains asbestos products. Selikoff, *E.P.A. Wins Suit on Demolition of Insulation*, INSULATION HYGIENE PROGRESS REP., Summer 1976, at 3.

¹⁹Annot., 51 A.L.R.3d 1344 (1973); 2 L. FRUMER & M. FRIEDMAN, PRODUCTS LIABILITY § 16A[4][e][i], at 3B-88-88.1 (1980); 1 R. HURSH & H. BAILEY, AMERICAN LAW OF PRODUCTS LIABILITY § 1:41, at 125 (2d ed. 1974); W. PROSSER, HANDBOOK OF THE LAW OF TORTS § 103 at 671-72 (4th ed. 1971).

²⁰IND. CODE § 33-1-1.5-3 (Supp. 1981). For an application of the identification re-

possible.²¹ Consequently, many asbestos plaintiffs must reshape existing theories of liability to deal with the peculiar factual background of asbestos litigation, or seek new theories of liability in which the burden of identifying the source of the injury-causing product is eliminated or shifted to the defendants.

The courts are just beginning to decide who shall bear the financial burden of these debilitating asbestos-related diseases when the plaintiff is unable to identify the source of the injury-causing products. This Note will analyze the propriety of using the traditional theories of alternative liability and concert of action in asbestos litigation. It will also discuss the new theory of market share liability which was recently developed to solve similar identification problems in DES cases, and will determine whether such a theory could apply to asbestos cases. Finally, this Note will discuss other possible solutions to the identification problem facing asbestos litigants.

II. TRADITIONAL THEORIES OF LIABILITY

A. *Alternative Liability*

Under existing tort law in most jurisdictions, there are two traditional theories which may ease the identification burden placed upon the asbestos plaintiff. One theory, that of alternative liability, originated in the California Supreme Court case of *Summers v. Tice*.²² Alternative liability is applied in cases where all defendants behaved tortiously but only one unidentifiable defendant actually caused the plaintiff's injury.²³ There must be uncertainty as to which defendant actually injured the plaintiff and relative certainty

quirement, see *American Optical Co. v. Weidenhamer*, 404 N.E.2d 606 (Ind. Ct. App. 1980).

²¹See, e.g., *Gray v. United States*, 445 F.Supp. 337 (S.D. Tex. 1978) (recovery denied for DES daughter unable to identify manufacturer of the injury-causing drug); *Davis v. Yearwood*, 612 S.W.2d 917 (Tenn. App. 1980) (plaintiffs, unable to identify the particular product which caused a fire in the padded cell of a jail, not allowed recovery). But see *Hall v. E. I. Du Pont De Nemours & Co.*, 345 F. Supp. 353 (E.D.N.Y. 1972) (plaintiff injured by a blasting cap could not identify specific manufacturer, allowed recovery on an enterprise liability theory); *Sindell v. Abbott Laboratories*, 26 Cal. 3d 588, 607 P.2d 924, 163 Cal. Rptr. 132, cert. denied, 449 U.S. 912 (1980) (DES daughter unable to identify specific manufacturer of injury-causing drug allowed recovery on a market share theory).

²²33 Cal. 2d 80, 199 P.2d 1 (1948). In *Summers*, the plaintiff and the two defendants had gone quail hunting. When the plaintiff flushed the quail out of their nests, the defendants fired their guns simultaneously and negligently in the plaintiff's direction, striking the plaintiff in the eye. Faced with two negligent defendants and a plaintiff, who, through no fault of his own, could not identify the responsible party, the court shifted the causation burden to the defendants holding both liable. *Id.* at 86-87, 199 P.2d at 4-5.

²³1 F. HARPER & F. JAMES, *THE LAW OF TORTS* § 10.1, at 702-04 (1956); W. PROS-

that one of the defendants did injure the plaintiff.²⁴ The burden of proof on the causation issue may then be shifted to the defendants to show that they were not responsible for the harm.²⁵ Joint and several liability is then imposed on all defendants who fail to meet this burden.²⁶ Although it has been argued that the defendants should have superior access to evidence of causation as a prerequisite to the court's shifting of the burden, it appears that the theory of alternative liability imposes no such requirement.²⁷

The traditional application of an alternative liability theory as presented by *Summers* poses many theoretical difficulties when applied to industry-wide litigation, such as asbestos litigation. In *Summers*, the total possible number of wrong-doers was two, both of whom were joined as defendants. Therefore, one of them must have been the cause in fact of the plaintiff's injury. By shifting the burden of proof and imposing joint and several liability, the court in *Summers* created the presumption that each defendant was the cause in fact of the plaintiff's injury. This shift in the burden of proof was justified *only* by the one hundred percent collective probability of causation.

In asbestos cases, it would be difficult, if not impossible, for the plaintiff to join all possible tortfeasors.²⁸ Joinder of less than all of

SER, *supra* note 19, at 243. This doctrine has also been incorporated into the RESTATEMENT (SECOND) OF TORTS § 433:

Where the conduct of two or more actors is tortious, and it is proved that harm has been caused to the plaintiff by only one of them, but there is uncertainty as to which one has caused it, the burden is upon each such actor to prove that he has not caused the harm.

RESTATEMENT (SECOND) OF TORTS § 433B(3) (1965) (illustration 9 is based on *Summers*).

²⁴RESTATEMENT (SECOND) OF TORTS § 433B(3) (1965).

²⁵33 Cal. 2d at 86-87, 199 P.2d at 4-5.

²⁶*Id.* at 84, 199 P.2d at 5.

²⁷The logic and policy justification behind the alternative liability theory in *Summers* was drawn from the case of *Ybarra v. Spangard*, 25 Cal. 2d 486, 154 P.2d 687 (1944), in which the doctrine of *res ipsa loquitur* was used to infer negligence. See *Sindell v. Abbott Laboratories*, 26 Cal. 3d 588, 599, 607 P.2d 924, 928-29, 163 Cal. Rptr. 132, 137-38 (1980). In *Ybarra*, the plaintiff allegedly suffered an injury during the course of surgery while he was unconscious. The court held that the burden of proof as to which defendant injured the plaintiff shifted to the defendants because the defendants had a superior ability to identify the specific instrumentality which injured the plaintiff. 25 Cal. 2d at 488, 154 P.2d at 690-91. However, in *Sindell*, the California Supreme Court specifically denied that superior knowledge or ability of the defendant to identify the specific instrumentality which injured the plaintiff was a prerequisite to the shifting of the burden of proof under the *Summers* doctrine. 26 Cal. 3d at 602, 607 P.2d at 930, 163 Cal. Rptr. at 138. *But see* *Namm v. Charles E. Frost & Co.*, 178 N.J. Super. 19, 427 A.2d 1121 (App. Div. 1981) (rejecting application of alternative liability on the basis of no superior knowledge).

²⁸The need to join numerous defendants poses problems in maintaining complete diversity of citizenship when the action is in federal court and problems in obtaining

the possible tortfeasors would undermine the theoretical justification for the alternative liability theory. Moreover, the equity of this theory diminishes as the disparity between the number of total possible tortfeasors and the number of tortfeasors joined becomes greater.²⁹ Because alternative liability calls for the imposition of joint and several liability upon all tortfeasors, it does not ensure equitable apportioning of liability among manufacturers.³⁰ Therefore, the alternative liability theory, in its traditional form, would not be appropriate in large industry-wide litigation,³¹ particularly in asbestos litigation in which not all causes of the plaintiff's injury can be isolated and identified.³²

B. Concert of Action

Concert of action is the second of the two theories under which a plaintiff may be able to obtain joint and several liability in

personal jurisdiction in both federal and state courts. Additionally, due to the latent effect of asbestos-related diseases, the asbestos plaintiff is often faced with the impossibility of joining a manufacturer which has gone out of business after the plaintiff's exposure.

²⁹See Comment, *DES and a Proposed Theory of Enterprise Liability*, 46 *FORDHAM L. REV.* 963, 991 (1978) [hereinafter cited as *FORDHAM Comment*].

³⁰The apportionment of damages under an alternative liability theory does not consider the length of exposure to various asbestos products and the relative propensity of each of these products to create asbestos dust when disturbed. The length of exposure to each asbestos product would be a necessary requirement in asbestos litigation. See notes 62-70 *infra* and accompanying text.

³¹Although alternative liability would not be applicable in its traditional form, a modified application is intimated by the *RESTATEMENT (SECOND) OF TORTS*. According to the *RESTATEMENT*, the burden of proof shifts to the defendants only if the plaintiff can demonstrate that all defendants acted tortiously and that the harm resulted from the conduct of one of them. *RESTATEMENT (SECOND) OF TORTS* § 433B, comment g (1977). The *RESTATEMENT* further notes that the rule thus far has been applied only where all the actors involved are joined as defendants and where the conduct of all is simultaneous, but cases may arise in which some modification of the rule would be necessary. *Id.*, comment h. This proposed modification has been accepted only in a few cases where joinder of all possible tortfeasors was impossible. See, e.g., *Haft v. Lone Palm Hotel*, 3 Cal. 3d 756, 478 P.2d 465, 91 Cal. Rptr. 745 (1970) (despite the fact that other persons not before the court could have caused the drownings, the court applied an alternative liability theory, shifting the burden of proof to the defendants); *Abel v. Eli Lilly & Co.*, 94 Mich. App. 59, 289 N.W.2d 20 (1979) (plaintiffs asserted that 16 defendants were the entire Michigan market for DES; however, the court did not condition liability on this factor, intimating that joinder of less than all possible defendants may be permissible). Other courts deciding DES cases have refused to expand the theory of alternative liability beyond its traditional application. See, e.g., *Sindell v. Abbott Laboratories*, 26 Cal. 3d 588, 607 P.2d 924, 163 Cal. Rptr. 132 (1980) (rejecting application of alternative liability because a major portion of the total number of possible tortfeasors were not joined).

³²See notes 73-77 *infra* and accompanying text.

asbestos suits. This theory was developed and traditionally applied in illegal drag racing cases in which a bystander was injured by one of the participants.³³ Under the concert of action theory, the injured bystander could proceed against any one or all of the participants in the drag race by alleging that each of the defendants helped plan or facilitate the illegal drag race, that such participation in the drag race was tortious, and that the bystander's injury resulted from the illegal drag race.³⁴ The bystander must also allege that an agreement existed between the participants. Such agreement may, however, be inferred from the participants' conduct.³⁵

To satisfy the cause in fact problems presented when more than two participants are involved,³⁶ the concert of action approach theorizes that the causative agent of the plaintiff's injury was the illegal car race itself, rather than using the traditional "but for" determination of cause in fact which would necessarily include only two participants. In this manner, each participant could be held liable as a "material element and substantial factor" in causing the plaintiff's injury, regardless of the fact that the absence of one participant would not have prevented the injury from occurring.³⁷

³³See, e.g., *Bierczynski v. Rogers*, 239 A.2d 218 (Del. 1968); *Skroh v. Newby*, 237 So. 2d 548 (Fla. Dist. Ct. App. 1970); *Lemons v. Kelly*, 239 Or. 354, 397 P.2d 784 (1964). See also W. PROSSER *supra* note 19, § 46, at 292. The RESTATEMENT (SECOND) OF TORTS sets forth the following elements for an action based upon concert of action:

For harm resulting to a third person from the tortious conduct of another, one is subject to liability if he

- (a) does a tortious act in concert with the other or pursuant to a common design with him, or
- (b) knows that the other's conduct constitutes a breach of duty and gives substantial assistance or encouragement to the other so to conduct himself, or
- (c) gives substantial assistance to the other in accomplishing a tortious result and his own conduct, separately considered, constitutes a breach of duty to the third person.

RESTATEMENT (SECOND) OF TORTS § 876 (1979).

³⁴W. PROSSER, *supra* note 19, § 46, at 291-92.

³⁵E.g., *Bierczynski v. Rogers*, 239 A.2d 218, 221 (Del. 1968) (agreement inferred from defendants' cars racing side by side at twice the legal speed limit); *Skroh v. Newby*, 237 So. 2d 548 (Fla. Dist. Ct. App. 1970) (agreement inferred from close proximity of cars, both of which were traveling at 90 miles per hour).

³⁶The "but for" definition of cause in fact establishes the outer limits of who may be held liable for the plaintiff's injury. If more than two people are involved in the illegal drag race, it could not realistically be said that "but for" the actions of the third person, the plaintiff would not have been injured. The race still could have taken place and injured the plaintiff without the third person. W. PROSSER, *supra* note 19, § 41, at 238-39.

³⁷Prosser suggests that being a "material element and substantial factor" in the plaintiff's injury would be a more preferable definition of cause in fact than the traditional "but for" definition. *Id.* at 240.

Under its traditional application, it is clear that the chief purpose of imposing joint liability under a concert of action theory was deterrence,³⁸ rather than an easing of the causal burden placed upon the plaintiff who was unable to identify the injury-producing party. Application of a concert of action theory has recently been used to establish industry-wide vicarious liability on the grounds that all members of that industry acted in concert by establishing a common design and safety standard for an allegedly defective product or by marketing such an allegedly defective product.³⁹ Such an application of the concert of action theory makes identification of the specific source of an injury-causing product unnecessary.

The usefulness of a concert of action theory by the asbestos plaintiff as a device to avoid the requirement of identifying the actual source of the injury-causing product is limited, for two essential reasons. First, most product liability actions involving asbestos are omission cases arising from the failure to test, warn, or otherwise anticipate and provide for the risk of injury.⁴⁰ The principle evidence of explicit agreement in asbestos cases involves the written correspondence of three representatives of two asbestos manufacturers between the years 1934 and 1939.⁴¹ This correspondence may indicate an interest of these manufacturers in suppressing information about the *possible* hazards of asbestos.⁴² Such correspondence is insufficient, however, to conclude that an express agreement existed between *all* asbestos manufacturers to suppress information concerning the hazards of asbestos. With respect to manufacturers other than these two, evidence consists of parallel activity⁴³ and the cooperation

³⁸*Id.* § 46, at 292.

³⁹*Hall v. E. I. Du Pont De Nemours & Co.*, 345 F. Supp. 353 (E.D.N.Y. 1972) (manufacturers of blasting caps and trade association not entitled to dismissal for plaintiffs' pleading of concert of action based upon defendants' agreement not to place warnings on blasting caps); *In re Beverly Hills Fire Litigation*, No. 77-79 (E.D. Ky. Nov. 14, 1979) (denied motion for summary judgment by manufacturers of aluminum wire and devices because evidence revealed genuine issue as to whether the defendants acted in concert in promoting and selling a defective product without adequate warning); *Bichler v. Eli Lilly & Co.*, No. 15600-1974 (N.Y. App. Div. July 16, 1979) (verdict in DES case for plaintiffs on the basis of defendants' conscious parallelism and tacit agreement in failing to conduct second-generation animal tests).

⁴⁰*Mansfield*, *supra* note 1, at 866.

⁴¹The representatives were Sumner Simpson, president of Raybestos-Manhattan, Vandiver Brown, secretary of Johns-Manville, and Mr. Hobart, Johns-Manville's New Jersey attorney. For excerpts of these letters, see Motley, *The Lid Comes Off*, TRIAL, April 1980, at 21-22. See note 107 *infra*.

⁴²Motley, *supra* note 41, at 21-23.

⁴³This parallel activity primarily consists of a universal failure by all manufacturers of asbestos products to place warning labels on their products. See note 112 *infra* and accompanying text.

of manufacturers within the industry.⁴⁴ Although the concert of action theory does not require an express agreement, it does, at a minimum, require a "tacit understanding."⁴⁵ An entire industry's failure to perform adequate testing or provide adequate warnings is generally insufficient to establish concert of action, and does not amount to a tacit understanding.⁴⁶ Based upon existing evidence, an application of concert of action in asbestos litigation would expand the doctrine far beyond its intended scope.

Second, in cases in which the plaintiff is unable to identify the source of the injury-causing products, concert of action fails to supply the theoretical basis for joining numerous defendants. Allowing the joinder of multiple defendants by the asbestos plaintiff who cannot identify the source of the injury-causing product would necessitate an expansion of the already liberal definition of cause in fact.⁴⁷ Because it cannot be proven that *all* defendants participated in injuring the plaintiff, this liberal definition would have to be expanded to include any material element and substantial factor which *may have* caused the plaintiff's injury. Such an expansion of the causation concept would undermine the notion of fault inherent in the traditional concert of action theory. Each defendant would be jointly and severally liable for the total damages on the basis of a theory without theoretical justification.

III. THE THEORY OF MARKET SHARE LIABILITY

Although the theories of alternative liability and concert of action, in their traditional form, do not appear to be of great value to the asbestos plaintiff who is unable to identify the source of the injury-causing product, the plaintiff may be aided by a new theory called market share liability. This approach was proposed and adopted by the California Supreme Court in *Sindell v. Abbott Laboratories*⁴⁸ to

"The cooperation between asbestos manufacturers could be inferred from the various industry associations to which these manufacturers belonged, such as the Asbestos Textile Institute (ATI). The ATI's decision not to conduct a study on animals to determine the carcinogenic effects of asbestos is cited as evidence of the cooperative relationship between asbestos textile manufacturers. Motley, *supra* note 41, at 23.

⁴⁵W. PROSSER, *supra* note 19, § 46, at 292.

⁴⁶*Sindell v. Abbott Laboratories*, 26 Cal. 3d 588, 605, 607 P.2d 924, 932, 163 Cal. Rptr. 132, 140, *cert. denied*, 449 U.S. 912 (1980). From the asbestos plaintiff's viewpoint, the most serious problem with relying on a concert of action theory would be the risk of a directed verdict where the court determines that there is insufficient evidence of agreement or tacit understanding among the defendants.

⁴⁷See notes 36-37 *supra* and accompanying text.

⁴⁸26 Cal. 3d 588, 607 P.2d 924, 163 Cal. Rptr. 132, *cert. denied*, 449 U.S. 912 (1980). The market share liability theory adopted in *Sindell* is derived from a theory proposed in a 1978 Comment in the *FORDHAM LAW REVIEW*. See *FORDHAM Comment*, *supra* note

ease the causal burden placed upon plaintiffs who experienced inherent difficulties in identifying the manufacturer of the injury-causing drug diethylstilbestrol (DES) that they were exposed to *in utero*.⁴⁹

To understand the implications of the market share theory, it is necessary to appreciate the causation problem presented by the DES cases. Generally, the plaintiffs in these cases are not able to identify the specific drug company which manufactured the pills which their mothers ingested. DES was never patented, and all manufacturers of DES followed a standard formula set forth in the United States Pharmacopeia.⁵⁰ DES was a prescription drug often sold through pharmacies under its generic name rather than a brand name.⁵¹ Furthermore, in the twenty to thirty years since the DES was prescribed, memories have faded and prescription records have often been lost or destroyed. Consequently, the particular manufacturer is unknown or unknowable to most DES plaintiffs.⁵²

Faced with the unique factual background of DES cases, the court in *Sindell* adopted a revolutionary theory of liability which obviates the DES plaintiff's difficulties in manufacturer identification while observing traditional notions of justice in only holding a manufacturer liable when there is actual proof that the manufacturer produced the DES which injured the plaintiff.⁵³ In adopting the

29. The court in *Sindell* made numerous references to this Comment and developed a theory which is nearly identical to the theory proposed by this Comment, even though the court in *Sindell* specifically distinguished its theory. 26 Cal. 3d at 608-09, 607 P.2d at 935, 136 Cal. Rptr. at 143.

⁴⁹Diethylstilbestrol is a synthetic estrogen which was first approved by the Food and Drug Administration (FDA) in 1947 to prevent miscarriages. 26 Cal. 3d at 593, 607 P.2d at 925, 163 Cal. Rptr. at 133. This drug was manufactured by hundreds of drug companies until 1971 when the FDA banned further marketing and promoting of DES as a miscarriage preventative. *Id.* at 594, 607 P.2d at 925, 163 Cal. Rptr. at 133. After being prescribed to several million pregnant women, research linked DES to cancerous and precancerous vaginal tract abnormalities in prenatally exposed daughters of women who took DES during their pregnancy. FORDHAM Comment, *supra* note 29, at 963-67. The form of cancer linked to DES use is adenocarcinoma which has a latency period of 10 to 12 years. Herbst, Ulfelder & Poskanzer, *Adenocarcinoma of the Vagina*, 284 NEW ENG. J. MED. 878 (1971).

⁵⁰21 U.S.C. § 351(b) (1976).

⁵¹FORDHAM Comment, *supra* note 29, at 976.

⁵²*Id.* at 974. In recent years, numerous law review articles have been published on the topic of DES and the difficulties with manufacturer identification. *See, e.g.*, FORDHAM Comment, *supra* note 29; Note, *Beyond Enterprise Liability in DES Cases—Sindell*, 14 IND. L. REV. 695 (1981); Note, *Market Share Liability: An Answer to the DES Causation Problem*, 94 HARV. L. REV. 668 (1981) [hereinafter cited as HARVARD Note]; Note, *Proof of Causation in Multi Party Drug Litigation*, 56 TEX. L. REV. 125 (1977).

⁵³26 Cal. 3d 588, 611-12, 607 P.2d 924, 937, 163 Cal. Rptr. 132, 145, *cert. denied*, 449 U.S. 912 (1980).

market share theory, the court in *Sindell* rejected the traditional theories of liability on which the plaintiffs were relying to ease the causal burden.⁵⁴ The market share theory is a hybrid theory, however, derived primarily from the *Summers* doctrine of alternative liability and, to a lesser extent, from the concert of action theory. The court held that because all defendants produced a drug from an identical formula, it is

reasonable in the present context to measure the likelihood that any of the defendants supplied the product which allegedly injured the plaintiff by the percentage which the DES sold by each of them for the purpose of preventing miscarriage bears to the entire production of the drug sold by all for that purpose.⁵⁵

Although it has been suggested that seventy-five to eighty percent of the market must be represented in a case before such liability is applied,⁵⁶ the *Sindell* court required only a "substantial per-

⁵⁴The *Sindell* court rejected an application of the *Summers* doctrine of alternative liability, recognizing that with only five of the two hundred DES manufacturers being defendants to this action, there was a significant possibility, perhaps a high probability, that the company which actually manufactured the particular DES causing the plaintiff's injury would escape liability. *Id.* at 611, 607 P.2d at 936-37, 163 Cal. Rptr. at 144-45. The *Sindell* court rejected the application of a concert of action theory because there was inadequate evidence in the record of an agreement or tacit understanding among the defendants to engage in tortious conduct. *Id.* at 605, 607 P.2d at 932-33, 163 Cal. Rptr. at 140-41. The court also considered the enterprise liability theory suggested in *Hall v. E. I. Du Pont De Nemours & Co.*, 345 F. Supp. 353 (E.D.N.Y. 1972), but rejected this theory because a large number of DES manufacturers were not joined in this action. 26 Cal. 3d at 607-11, 607 P.2d at 933-35, 163 Cal. Rptr. at 141-43. In *Hall*, there were only six manufacturers of blasting caps, all of which were joined in the action. Furthermore, the conclusion in *Hall* that the defendants jointly controlled the risk to the plaintiffs based on allegations that functions related to safety had been delegated to a trade association, was absent from the *Sindell* case. *Id.* The major drawback of the *Hall* theory is the application of vicarious liability, rather than a shifting of the burden of proof. Also, the theory is inherently contradictory: parties who are acting independently *a fortiori* do not have joint control of risk. As a consequence, few jurisdictions have been willing to adopt the *Hall* theory of enterprise liability.

⁵⁵26 Cal. 3d at 611-12, 607 P.2d at 937, 163 Cal. Rptr. at 145.

⁵⁶FORDHAM Comment, *supra* note 29, at 995. This Comment suggested requiring the following elements in an enterprise liability theory:

- (1) Plaintiff is not at fault for his inability to identify the causative agent and such liability is due to the nature of the defendants' conduct.
- (2) A generically similar defective product was manufactured by all the defendants.
- (3) Plaintiff's injury was caused by this product defect.
- (4) The defendants owed a duty to the class of which plaintiff was a member.
- (5) There is clear and convincing evidence that plaintiff's injury was caused by the product of one of the defendants. For example, the joined defend-

centage" of the total market.⁵⁷ Once the plaintiff has joined the manufacturers of a substantial share of the relevant market in the action, the burden of proof shifts to each defendant to demonstrate that it could not have made the particular substance which injured the plaintiff.⁵⁸ If the defendant can not so demonstrate, then "[e]ach defendant will be held liable for the proportion of the judgment represented by its share of that market unless it demonstrates that it could not have made the product which caused the plaintiff's injuries."⁵⁹

The policy underlying *Sindell* is that "as between an innocent plaintiff and negligent defendants, the latter should bear the cost of the injury."⁶⁰ This policy was, in the court's view, applicable in the DES litigation because the plaintiffs were totally innocent in failing to provide evidence of causation. In addition, the court found, "[f]rom a broader policy standpoint, [the] defendants are better able to bear the cost of injury resulting from the manufacture of a defective product."⁶¹

Essentially, the DES plaintiff need only prove the following under market share liability: that the defendants were negligent either by their knowledge that DES was carcinogenic or by their failure to properly test the drug prior to marketing; that the defendants produced a generically similar defective product with inadequate warnings of the dangers associated with taking DES; and that the plaintiff was injured by DES. In proving these elements, the plaintiff has a cause of action against DES manufacturers so long as a substantial share of the relevant market can be joined. The

ants accounted for a high percentage of such defective products on the market at the time of plaintiff's injury.

(6) There existed an insufficient, industry-wide standard of safety as to the manufacture of this product.

(7) All defendants were tortfeasors satisfying the requirements of whichever cause of action is proposed: negligence, warranty, or strict liability.

Id. at 955. Most of these elements appear in the market share theory adopted by the *Sindell* court. For an excellent analysis of the differences between these two theories of industry-wide liability, see Note, *Industry-Wide Liability and Market Share Allocation of Damages*, 15 GA. L. REV. 423 (1981).

⁵⁷26 Cal. 3d at 612, 607 P.2d at 937, 163 Cal. Rptr. at 145.

⁵⁸The shift in burden of proof for manufacturer identification represents a substantive shift in burden and not merely a procedural shift. The effect is to eliminate the identification requirement of traditional tort law. Berns & Lykos, *Sindell v. Abbott Labs—The Heir of the Citadel*, 15 FORUM 1031, 1035 (1980).

⁵⁹26 Cal. 3d at 612, 607 P.2d at 937, 163 Cal. Rptr. at 145. Although the court did not specify whether the appropriate market shares would be determined as of the time of ingestion or the time of judgment, it is reasonable to assume that the court intended that market shares be determined as of the time of ingestion.

⁶⁰*Id.* at 610-11, 607 P.2d at 936, 163 Cal. Rptr. at 144.

⁶¹*Id.*

obvious question in asbestos litigation is whether such a theory would be available to the asbestos plaintiff who is unable to identify the source of the injury-causing product.

IV. APPLICABILITY OF MARKET SHARE LIABILITY TO ASBESTOS LITIGATION

To properly analyze the applicability of a market share liability theory to asbestos litigation, it is necessary to review the underlying justifications for such a theory and apply the required elements of the market share theory to the asbestos situation.

A. *Requirement of Fungible Products*

Of critical importance to the market share theory is the requirement of generically similar defective products. Because all defendants in the DES cases produced a drug from an identical formula,⁶² the pills were equally harmful regardless of who manufactured them. Therefore, the total volume of DES marketed in the year of injury directly corresponded to the amount of risk created and relative harm caused by each manufacturer.⁶³ Where the products are not uniformly harmful, the logical correlation between the volume sold and the harm caused by each manufacturer would be lost, unless the market share approach also considered the relative harmfulness of each manufacturer's product.⁶⁴

Asbestos plaintiffs generally have been exposed to a wide variety of not generically similar products containing asbestos.⁶⁵ The

⁶²See note 50 *supra* and accompanying text.

⁶³The FORDHAM Comment explains the relationship between the percentage of market share and liability as follows:

[I]f X Manufacturer sold one-fifth of all the DES prescribed for pregnancy and identification could be made in all cases, X would be the sole defendant in approximately one-fifth of all cases and liable for all the damages in those cases. Under alternative liability, X would be joined in all cases in which identification could not be made, but liable for only one-fifth of the total damages in these cases. X would pay the same amount either way. Although the correlation is not, in practice, perfect, it is close enough so that defendant's objections on the ground of fairness lose their value.

FORDHAM Comment, *supra* note 29, at 994 (footnote omitted). The court in *Sindell* adopted this explanation theorizing that, "[u]nder this approach, each manufacturer's liability would approximate its responsibility for the injuries caused by its own products." 26 Cal. 3d at 612, 607 P.2d at 937, 163 Cal. Rptr. at 145.

⁶⁴HARVARD Note, *supra* note 52, at 679.

⁶⁵*E.g.*, Memorandum of Johns-Manville Products Corporation in Opposition to the Plaintiffs' Motion to Amend Complaint at 19, *Neary v. Johns-Manville Prod. Corp.*, No. H78-790 (D. Md., filed May 5, 1978) (plaintiff alleged exposure over decades to molded pipe and block insulation, asbestos cloth, insulating and finishing asbestos cement, asbestos paper, and other asbestos products).

probability that these plaintiffs were actually harmed by any particular asbestos product is a function of the amount and percentage of asbestos in each product and the tendency of the asbestos to free itself from that product.⁶⁶ Therefore, in order for the determination of market share to have any logical relationship to the amount of risk created by each manufacturer and the probability that its products caused the plaintiff's injury, the market share determination would have to incorporate these factors.

Although the amount and percentage of asbestos in each manufacturer's products generally can be ascertained, the determination of the relative propensity of each product to release asbestos is much more difficult and speculative. For instance, asbestos bonded in a finished product, such as linoleum, does not present significant health risks, unless the product is damaged or disturbed in such a way as to free fibers into the air.⁶⁷ On the other hand, spray asbestos insulation, which has a very high propensity to release asbestos dust, is extremely dangerous to health.⁶⁸ Between these two extremes are asbestos cement, molded pipe covering, asbestos clothing, asbestos ceiling tiles, and a host of other asbestos products, each of which has a different propensity to release asbestos fibers into the air. The determination is further complicated by the varying tendencies of each particular product to release asbestos fibers depending upon when the exposure occurred and the method of application or use of the product. Although bonded asbestos products may present little health risk in their finished form, the health risk is significantly greater during the manufacturing process. Furthermore, the method in which a product is used or applied plays an important role in determining the propensity of that product to release asbestos fibers.⁶⁹ The failure to consider these factors might result in one manufacturer, who produced a bonded product containing only two percent asbestos, sharing *equal* liability with another manufacturer who produced a product containing eighty percent asbestos which required spray application. These two products could not reasonably share an equal probability of causing the plaintiff's injuries.

⁶⁶*Id.*

⁶⁷Bruck, *The Armies of Asbestos*, AM. LAW., Nov. 1979, at 20; DHEW ASBESTOS EXPOSURE, *supra* note 2, at 4.

⁶⁸Selikoff, *A Gloomy Picture*, INSULATION HYGIENE PROGRESS REP., Winter 1972, at 1.

⁶⁹Selikoff, *Insulation Industry Hygiene Research Program*, INSULATION HYGIENE PROGRESS REP., Winter 1972, at 15-16 (dumping dry asbestos cement into trough prior to adding water creates more dust than adding asbestos cement to water; wetting pipe covering prior to cutting creates less dust than without wetting; cutting asbestos products with saber saw creates more dust than cutting with band saw which has dust collector).

As an additional consideration, medical studies on asbestos exposure indicate that the diseases linked with asbestos inhalation increase in severity in a direct relationship to the length of exposure to asbestos dust.⁷⁰ Therefore, the length of exposure to each product should be factored into the market share equation.

From the above analysis, it is readily apparent why the court in *Sindell* placed so much emphasis on the fungibility of DES. The lack of generically similar defective products injects serious practical and theoretical difficulties into the application of the market share theory. A rote application of this theory to asbestos litigation without considering the relative harm which each product causes, would destroy the underlying justifications of the market share theory and impose liability on one manufacturer for another manufacturer's dissimilar defective products.

B. Relevant Market Requirement

Implicit in the *Sindell* formulation of the market share theory is the requirement of a definite, determinable market for the DES to which the plaintiff was exposed. Because it can be assumed that most mothers during their pregnancy remain in the same geographical area, a local market is both logical and readily ascertainable. By determining the relevant local market, all defendants who did not distribute their product within that geographic area during the period in which the mother was exposed to DES can be excused from the action.⁷¹ The probability that one of the limited number of named defendants actually caused the plaintiff's injury is thereby increased.

Because many asbestos plaintiffs have been exposed to a wide variety of products over decades, the determination of a relevant local market in an asbestos suit would be highly complex. In each geographic area where the plaintiff was exposed to asbestos dust, a determination would have to be made concerning each defendant's share of the local market. Presumably, after all local markets are determined, an average market share for each defendant could be computed. This average market share, however, would also need to be weighted by the plaintiff's length of exposure in each local market.⁷² Alternatively, if there was no attempt made to identify local markets and a national market was assumed, the results could

⁷⁰Selikoff, Hammond & Seidman, *Cancer Risk of Insulation Workers in the United States*, INSULATION HYGIENE PROGRESS REP., Fall 1974, at 6; See also Mansfield, *supra* note 1 at 861.

⁷¹*Sindell v. Abbott Laboratories*, 26 Cal. 3d at 611-12, 607 P.2d at 937, 163 Cal. Rptr. at 147.

⁷²See note 70 *supra* and accompanying text.

prove extremely harsh and inequitable. A manufacturer who controlled an extremely high percentage of the national market, but only a small percentage of the local market where the plaintiff was actually exposed, would be subject to a very large percentage of the judgment even though it controlled only a very small proportionate share of the relevant local market. Therefore, if the determination of market share is to have any logical relationship to the degree of each defendant's culpability, an effort must be made to define the relevant local markets and consider the relative lengths of plaintiff's exposure in each market.

C. Medical Causation

In addition to defining a relevant geographic market, the determination of a relevant market would need to include all possible sources of the plaintiff's injury. Asbestosis, pulmonary and bronchogenic carcinoma, and mesothelioma are not uniquely caused by and specifically traceable to asbestos exposure. A recent study by the National Cancer Institute concluded that the carcinogenic effect of asbestos is primarily related to its structural shape rather than its physiochemical properties.⁷³ Medical evidence indicates that pulmonary fibrosis, with symptoms identical to asbestosis symptoms, may be caused by the inhalation of numerous other types of fibrous dusts and chemicals.⁷⁴ Secondly, pulmonary and bronchogenic carcinoma are common diseases which generally result from a combination of carcinogens.⁷⁵ Consequently, it is nearly impossible to isolate the particular causative agents in carcinoma cases.⁷⁶ Thirdly, although it was once thought that mesothelioma was uniquely associated with asbestos exposure, medical evidence suggests that the inhalation of any inorganic fibrous material may cause mesothelioma.⁷⁷

⁷³Stanton & Wrench, *Mechanism of Mesothelioma Induction with Asbestos and Fibrous Glass*, 48 J. NAT'L CANCER INST. 797 (1972).

⁷⁴Deposition of Dr. Hardy, *supra* note 5, at 20; Mansfield, *supra* note 1, at 862-63. For a detailed description of asbestosis, see note 5 *supra*.

⁷⁵Deposition of Dr. Hardy, *supra* note 5, at 27. Henderson, *Environment*, TRIAL, Feb. 1978, at 6. Examples of other carcinogens which cause pulmonary cancer are: chromates, nickel, coke oven emissions, cigarette smoke, uranium, and arsenic. Speech by Peter Shea, Home Office Supervising Examiner for Liberty Mutual Insurance Co., Boston, Mass., to the Association of Insurance Attorneys, March 21, 1980. For a description of these diseases, see note 6 *supra*.

⁷⁶Mansfield, *supra* note 1, at 863.

⁷⁷Medical science has linked mesothelioma to such other inorganic sources as fibrous glass and polyurethane foam. Selikoff, *Caution Essential in Use of All Insulation Material*, INSULATION HYGIENE PROGRESS REP., Summer 1972, at 3 (five varieties of fibrous glass were applied to pleura of rats, and all developed mesothelioma) (citing Stanton & Wrench, *Mechanism of Mesothelioma Induction with Asbestos and*

The market share calculation logically requires the consideration of all possible sources of the asbestos plaintiff's disease.⁷⁸ For example, cigarette smoking, like asbestos exposure, increases the incidence of pulmonary fibrosis and bronchogenic carcinoma, but cannot be isolated from other factors also causing these diseases.⁷⁹ Furthermore, the combined effects of cigarette smoking and asbestos exposure geometrically increase an individual's risk of fatal lung cancer over individuals who either smoke or are exposed to asbestos but not both. Specifically, the asbestos worker who smokes faces a risk of fatal lung cancer ten times greater than the asbestos worker who does not smoke.⁸⁰

If a plaintiff has a history of cigarette smoking and asbestos exposure, the market share calculation would have to make a preliminary determination of the percentage contribution to the plaintiff's disease which each of these factors played.⁸¹ It can be hypothesized that there was an eighty percent chance that the plaintiff's disease was caused by asbestos exposure and a twenty percent chance that the disease was caused by cigarette smoking.⁸² If a manufacturer of asbestos products controlled thirty percent of the relevant asbestos market, its share of responsibility for asbestos-related injuries would be twenty-four percent.⁸³ Such computations would have to be made for all possible sources of the plaintiff's

Fibrous Glass, 48 J. NAT'L CANCER INST. 797 (1972)). Later studies by the National Cancer Institute confirmed these results. Selikoff, *Dust Control Important in Alaskan Pipeline Work*, INSULATION HYGIENE PROGRESS REP., Summer 1974, at 2. This conclusion suggests that any inorganic fibrous material which may be inhaled has the potential of causing mesothelioma. Selikoff, *Caution Essential in Use of All Insulation Material*, INSULATION HYGIENE PROGRESS REP., Summer 1972, at 3. For a description of the disease mesothelioma, see note 7 *supra*.

⁷⁸HARVARD Note, *supra* note 52, at 678.

⁷⁹See U.S. DEPT OF HEALTH, EDUC., AND WELFARE, SMOKING AND HEALTH, 4-63 to -66, 5-25 to -29 (1978). However, there is no evidence that smoking increases the risk of mesothelioma among asbestos workers. Mehaffy, *supra* note 1, at 345.

⁸⁰The results of a recent study on death rates from lung cancer (per 100,000 man-years, standardized for age) were as follows:

11.3 for men who neither worked with asbestos nor smoked cigarettes, 58.4 for men who worked with asbestos but did not smoke, 122.6 for cigarette smokers who had not worked with asbestos, 601.6 for those unfortunate enough to have had both exposures—cigarettes and asbestos.

Selikoff & Hammond, *Asbestos and Smoking*, 242 J. A.M.A. 458 (1979).

⁸¹Such a determination may prove to be medically impossible. See note 79 *supra*. However, from a statistical standpoint such a determination might be made. See notes 126-28 *infra* and accompanying text.

⁸²If cigarette manufacturers could not be held liable due to appropriate warnings on each package consistent with the "state of the art," then plaintiffs may be held 20% contributorily negligent.

⁸³ $30\% \times 80\% = 24\%$.

disease. Failure to consider all of the possible sources of injury would result in one group of manufacturers, whose products contained the particular carcinogen considered in the market share computation, bearing a greater proportion of the judgment than that for which they are logically responsible.⁸⁴

D. Requirement of Joining a Substantial Share

In accordance with the market share theory as set forth in *Sindell*, the asbestos plaintiff would need to join a "substantial share" of the relevant market.⁸⁵ The court in *Sindell* reasoned that joinder of the manufacturers of a substantial share of the DES which the plaintiff's mother may have taken, would significantly diminish the injustice of shifting the burden of proof to the defendants to demonstrate that they could not have made the particular DES which injured the plaintiff.⁸⁶ This reasoning is logically sound when applied to DES cases because the DES plaintiff's cancer is uniquely caused by and traceable to DES.⁸⁷ In DES cases, the court can determine with reasonable accuracy whether the defendants joined in the action collectively distributed a substantial share of the product which caused the plaintiff's injury.

Implicit in the requirement of joining a substantial share of the relevant market is the knowledge of all possible sources of the plaintiff's injuries. In asbestos litigation, the plaintiff's injuries generally can not be traced solely to asbestos exposure.⁸⁸ Asbestos-related diseases may result from the combined effects of asbestos exposure and numerous other carcinogens to which the plaintiff was exposed. The plaintiff who has been exposed to asbestos and who also has a history of exposure to other carcinogens, not only would have to join a substantial share of the relevant asbestos market, but also would have to join a substantial share of the markets for all other carcinogens to which he was exposed.

With reference to the example above, where there exists an eighty percent chance that the plaintiff's injuries were caused by asbestos exposure and a twenty percent chance that the injuries were caused by cigarette smoking, joining one hundred percent of

⁸⁴In the example above, considering a plaintiff who was exposed to cigarette smoke and asbestos dust, the asbestos manufacturer would only be responsible for 24% of the damages. A failure to consider the cigarette smoke would render this manufacturer liable for 30% of the plaintiff's injuries.

⁸⁵See note 57 *supra* and accompanying text.

⁸⁶26 Cal. 3d at 612, 607 P.2d at 937, 163 Cal. Rptr. at 145.

⁸⁷FORDHAM Comment, *supra* note 29, at 965 n.8 (citing Ulfelder, *The Stilbestrol-Adenosis Carcinoma Syndrome*, 38 *CANCER* 426, 428 (1976)).

⁸⁸See notes 74-77 *supra* and accompanying text.

the possible asbestos sources would only constitute eighty percent of the possible sources of the plaintiff's injuries. A failure to join a substantial share of all relevant markets may prove to be inadequate to overcome the injustice of shifting the burden of proof to the defendants in asbestos litigation under a market share liability approach. All possible sources of the plaintiff's injuries should be considered if the market share theory is to maintain any rational relationship between the injuries sustained and the defendants' relative culpability. It should be noted, however, that the joinder of non-asbestos defendants may be frustrated by the procedural requirement which allows permissive joinder of parties only where there exist questions of law or fact common to all parties.⁸⁹

*E. Requirement That All Defendants Be Shown
to Have Sold a Defective Product*

Under both the alternative liability and concert of action theories, it is incumbent upon the plaintiff to prove that all defendants were negligent.⁹⁰ Under a strict liability theory, the plaintiff must prove that all of the defendants sold an unreasonably dangerous and defective product which caused the plaintiff's injuries.⁹¹ Consistent with these theories, the court in *Sindell* formulated the market share theory on the supposition that all defendants can be shown to have sold a defective product and that injury resulted from the conduct common to all defendants.⁹² In distinguishing earlier cases in which the California Supreme Court refused to expand the *Summers* alternative liability theory to include situations in which the plaintiff could not establish that all defendants were negligent, the court in *Sindell* stated that, "[h]ere, by contrast, the DES manufactured by *all* defendants is alleged to be defective"⁹³ It is clear from this distinction, that by holding the defendants liable only where it could be established that all defendants either were negligent or sold a defective product, the court in *Sindell* wanted to maintain the justice of earlier case law. The presumption that all DES manufacturers were tortfeasors was

⁸⁹FED. R. CIV. P. 20.

⁹⁰See notes 23 & 33 *supra*.

⁹¹RESTATEMENT (SECOND) OF TORTS § 402A (1965) (codified at IND. CODE § 33-1-1.5-3 (Supp. 1981)).

⁹²The question presented to the court in *Sindell* was whether to sustain the defendants' demurrers; therefore, the court assumed as true the plaintiff's allegations that the defendants sold defective products. 26 Cal. 3d at 595-96, 607 P.2d at 926-27, 163 Cal. Rptr. at 134-35.

⁹³26 Cal. 3d at 603 n.18, 607 P.2d at 931 n.18, 163 Cal. Rptr. at 139 n.18 (emphasis added) (distinguishing *Wetzel v. Eaton Corp.*, 62 F.R.D. 22 (D. Minn. 1973) and *Garcia v. Joseph Vince Co.*, 84 Cal. App. 3d 868, 148 Cal. Rptr. 843 (1978)).

based on the production of a generically identical defective product by all defendants.⁹⁴

In contrast, the asbestos manufacturers did not produce generically identical defective products; instead, they manufactured and sold thousands of different types of asbestos products, each of which had a different propensity to release asbestos dust.⁹⁵ Unlike DES, there are some asbestos products which present little or no health risk;⁹⁶ moreover, it is believed there are safe levels of exposure to asbestos dust.⁹⁷ Therefore, it can not be presumed that all asbestos manufacturers were negligent nor can it be presumed that all asbestos manufacturers sold unreasonably dangerous defective products. In order to demonstrate that all asbestos defendants are tortfeasors, the plaintiff must establish that all defendants acted in concert by failing to test, warn, or otherwise anticipate and provide for the risk of injury. Although there is some evidence that certain asbestos manufacturers either knew or should have known of the dangers of asbestos inhalation, this cannot be assumed for all asbestos manufacturers.

The first reported case of an asbestos-related disease was disclosed in an unpublished report presented by Dr. H. Montagu-Murry in England in 1906.⁹⁸ In 1924, W. E. Cooke reported the first published instance of a death presumed related to asbestos exposure.⁹⁹ Cooke's report marked the turning point in asbestos research, capturing the interest of numerous British physicians.¹⁰⁰

Concerned by these British reports, two American manufacturers of asbestos products, Johns-Manville and Raybestos-Manhattan, along with their insurance carrier, Metropolitan Life Insurance Company, in 1929 funded a research program headed by Dr. Anthony Lanza.¹⁰¹ The results of the study were published in 1935 indicating that fifty-five percent of these workers had positive lung

⁹⁴26 Cal. 3d at 610-11, 607 P.2d at 936, 163 Cal. Rptr. at 144.

⁹⁵See notes 65-69 *supra* and accompanying text.

⁹⁶See Cooke, *Asbestos Dust and the Curious Bodies Found in Pulmonary Asbestosis*, 2 BRIT. MED. J. 578 (1929).

⁹⁷See notes 67-69 *supra* and accompanying text.

⁹⁸Felton, *The Prevention of Asbestos-Related Diseases*, in ASBESTOS: PROPERTIES, APPLICATIONS, AND HAZARDS 496 (Michaels & Chissick ed. 1979).

⁹⁹Cooke, *Fibrosis of the Lungs Due to the Inhalation of Asbestos Dust*, 2 BRIT. MED. J. 147 (1924).

¹⁰⁰See, e.g., Haddow, *Clinical Aspects of Pulmonary Asbestosis*, 1929 BRIT. MED. J. 580; Merewether, *A Memorandum on Asbestosis*, (pts. 1-3) 1933-34 TUBERCLE 69, 109, 152; Merewether, *The Occurrence of Pulmonary Fibrosis and Other Pulmonary Affections in Asbestos Workers*, (pts. 1-2) 1930 J. INDUS. HYGIENE 198, 239; Seiler, *A Case of Pneumoconiosis*, 1928 BRIT. MED. J. 982; Wood, *Pulmonary Asbestosis*, 1929 TUBERCLE 353; Wood & Gloyne, *Pulmonary Asbestosis*, 1930 LANCET 445.

¹⁰¹Motley, *supra* note 41, at 22.

damage while only seventeen percent were asymptomatic.¹⁰² One of the few American doctors who devoted time and research to the asbestos problem before the mid-1930's was Dr. K. A. Lynch. Dr. Lynch's articles, however, received little attention in the medical field.¹⁰³ Like the early British medical literature, the Lynch studies, the Lanza studies, and the other American studies dealt almost exclusively with the effect of asbestos inhalation on asbestos textile workers and mine workers.¹⁰⁴ None of these studies examined the effects of asbestos exposure on shipyard workers, insulation workers, bystanders, or consumers.¹⁰⁵

In 1937, Dr. LeRoy V. Gardner at the Saranac Laboratory, Saranac Lake, New York, began asbestos dust research at the request of, and with the financial backing of ten American manufacturers of asbestos products.¹⁰⁶ The Saranac study continued into the 1960's, but no articles or papers of any kind were released on asbestos-related diseases.¹⁰⁷ In 1946, the Fleischer-Drinker Re-

¹⁰²Lanza, McConnell, & Fehnel, *Effects of the Inhalation of Asbestos Dust on the Lungs of Asbestos Workers*, 50 PUB. HEALTH REP. 1, 7-8 (1935). Although the Lanza Study concludes that prolonged exposure to asbestos dust causes a pulmonary fibrosis of a type milder than silicosis, correspondence from Vandiver Brown, secretary of Johns-Manville, to Dr. Lanza on December 10, 1934, indicates that such a conclusion was made at the request of Johns-Manville. See Motley, *supra* note 41, at 22.

¹⁰³Deposition of Dr. Hardy, *supra* note 5, at 38-40. During the middle to late 1930s infrequent studies and reports were being added to American medical literature on the subjects of asbestosis and bronchogenic carcinoma. See, e.g., Donnelly, *Pulmonary Asbestosis*, 23 AM. J. PUB. HEALTH 1275 (1934); Lanza, *Asbestosis*, 1936 J. A.M.A. 368; McPheeters, *A Survey of a Group of Employees Exposed to Asbestos Dust*, 18 J. INDUS. HYGIENE 229 (1936); Stone, *Clinical Studies in Asbestosis*, 41 AM. REV. TUBERCULOSIS 12 (1940); Egbert & Geiger, *Pulmonary Asbestosis and Carcinoma*, 34 AM. REV. TUBERCULOSIS 143 (1936).

¹⁰⁴See medical literature in notes 98-103 *supra*.

¹⁰⁵*Id.*

¹⁰⁶These manufacturers were:

1. Johns-Manville
2. Thermoid Rubber and Southern Asbestos
3. Keasbey & Mattison (predecessor of Nicolet Industries, Inc.)
4. Asbestos Manufacturing
5. Russell Manufacturing
6. Raybestos-Manhattan, Inc.
7. American Brake Block Corp.
8. Gatke Corp.
9. United Asbestos & Rubber Co. (UNARCO)
10. United States Gypsum Co.

Plaintiff's Contentions at 7, Hartnagle v. Johns-Manville Sales Corp., No. IP80-66C (S.D. Ind., filed Jan. 30, 1980).

¹⁰⁷Deposition of Dr. Hardy, *supra* note 5, at 47-48. Dr. Hardy was involved with the Saranac research from 1945-46. *Id.* at 45. Correspondence in 1936 among Sumner Simpson, president of Raybestos-Manhattan, Vandiver Brown, secretary of Johns-Manville, and Dr. LeRoy V. Gardner, Chief Investigator at Saranac Laboratories, sug-

port¹⁰⁸ was published. This report, the first to specifically study the effects of asbestos on insulation workers, concluded that pipe covering operations on naval vessels were relatively safe.¹⁰⁹ This conclusion was not contradicted by any major asbestos study until 1964.¹¹⁰

The present awareness of the debilitating effect of the diseases linked to asbestos and of the number of those affected by asbestos exposure is the result of massive epidemiological studies conducted during the mid-1960's and 1970's. In 1964 and 1965, Dr. Irving Selikoff and the Mount Sinai School of Medicine published comprehensive and well-documented studies warning insulation workers of the extreme hazards of asbestos insulation.¹¹¹ In these same two years, warning labels began appearing on products containing asbestos; by 1967, warning labels could be found on virtually all products containing asbestos.¹¹² At this same time, most work areas

gests that as a condition to the funding of the Saranac Study, all results obtained were to be considered the property of those who advanced the funds. Furthermore, all decisions on whether such results were to be published were to be made by the sponsors. Motley, *supra* note 41, at 22-23. (excerpts of this correspondence).

¹⁰⁸Fleischer & Drinker, *A Health Survey of Pipe Covering Operations in Constructing Naval Vessels*, 28 J. INDUS. HYGIENE TOXICOLOGY 9 (1946).

¹⁰⁹*Id.* at 13. It has been suggested that this misleading conclusion was due to the authors' failure to recognize the long latency period of asbestos-related diseases. Deposition of Dr. Hardy, *supra* note 5, at 87.

¹¹⁰Deposition of Dr. Hardy, *supra* note 5, at 86-87. Although numerous research programs on the relationship of asbestos fiber inhalation to bronchogenic carcinoma and asbestosis were undertaken during the late 1940's and 1950's, these studies were minor and were not widely relied upon by the medical community. *Id.* See, e.g., Cureton, *Squamous Cell Carcinoma Occurring in Asbestosis of the Lung*, 2 BRIT. J. CANCER 249 (1948); Doll, *Mortality for Lung Cancer in Asbestos Workers*, 12 BRIT. J. INDUS. MED. 81 (1955); Isselbacher, Klaus, Hanna, Hardy & Harriet, *Asbestosis and Bronchogenic Carcinoma*, 15 AM. J. MED. 721 (1953); Lynch & Cannon, *Asbestosis: Analysis of Forty Necropsied Cases*, 14 DISEASES OF THE CHEST 874 (1948); Smith, *Survey of Some Current British and European Studies of Occupational Tumor Problems*, 5 A.M.A. ARCH. INDUS. HYGIENE, OCCUPATIONAL MED. 242 (1951); Stoll, Bass & Angrist, *Asbestosis Associated with Bronchogenic Carcinoma*, 88 ARCH. INTERNAL MED. 831 (1951); Wagner, *Diffuse Pleural Mesothelioma and Asbestos Exposure in the North Western Cape Province*, 17 BRIT. J. INDUS. MED. 260 (1960) (first study to link asbestos exposure with mesothelioma).

¹¹¹Selikoff, Churg & Hammond, *Asbestos Exposure and Neoplasia*, 188 J. A.M.A. 22 (1964); Selikoff, Churg & Hammond, *The Occurrence of Asbestosis Among Insulation Workers in the United States*, 132 ANNALS N.Y. ACAD. SCI. 139 (1965).

¹¹²Mehaffy, *supra* note 1, at 345. The first warning labels were similar to the following:

CAUTION

THIS PRODUCT CONTAINS ASBESTOS FIBER. INHALATION OF ASBESTOS IN EXCESSIVE QUANTITIES OVER LONG PERIODS OF TIME MAY BE HARMFUL.

IF DUST IS CREATED WHEN THIS PRODUCT IS HANDLED, AVOID BREATHING THE DUST. IF ADEQUATE VENTILATION CONTROL IS

were in compliance with governmental standards for permissible levels of asbestos dust.¹¹³ It was not until 1974 that this standard was determined to be ineffective by a federal court of appeals.¹¹⁴

As indicated by the above history, it cannot be said that asbestos manufacturers, on a collective basis, knew or should have known that their type of product was dangerous, nor can it be presumed that *all* manufacturers of asbestos products were negligent. The mere fact that numerous manufacturers included asbestos as a component part of their dissimilar products may not, in itself, justify the imposition of market share liability.

V. A POSSIBLE SOLUTION

Although the market share liability theory, as formulated in *Sindell*, can not be strictly applied to asbestos litigation, the market share theory does provide a sound policy foundation supporting the imposition of liability in asbestos cases. By holding each defendant liable for approximately the same amount of losses as were actually caused by its production of DES,¹¹⁵ the court in *Sindell* relied on traditional concepts of fault and on the broader policy that the manufacturer is better able to bear the loss through insurance and distribute this loss among the public as a cost of doing business.¹¹⁶ The latter rationale is a resource allocation and risk distribution concept which utilizes the marketplace not only for the original allocation of resources but also for the distribution of losses. The resource allocation and risk distribution concept requires that the cost of injury be borne by the industry which creates the risk because the injury, regardless of fault, is a cost of such industry activity.¹¹⁷ Furthermore, this concept requires that the loss be borne

NOT POSSIBLE, WEAR RESPIRATORS APPROVED BY THE U.S. BUREAU OF MINES FOR PNEUMOCONIOSIS PRODUCING DUSTS.

See *Borel v. Fibreboard Paper Prod. Corp.*, 493 F.2d 1076, 1104 (5th Cir. 1973), *cert. denied*, 419 U.S. 869 (1974). In 1973, the court in *Borel* found that a warning label similar to the example above, was inadequate to communicate the dangers of asbestos exposure to workers. *Id.* at 1106.

¹¹³Selikoff, *Proposed Standard for Workers Questioned*, INSULATION HYGIENE PROGRESS REP., Summer 1971, at 3. The American Conference of Governmental Industrial Hygienists adopted the standard of five million particles per cubic foot in 1968. In 1971, the standard was revised to five fibers per cubic centimeter. *Asbestos Comment*, *supra* note 8, at 65-66. This standard became legally enforceable under the Walsh-Healy Act. 41 U.S.C. § 35-45 (1976).

¹¹⁴Selikoff, *Court of Appeals Orders Review of Asbestos Standard*, INSULATION HYGIENE PROGRESS REP., Summer 1974, at 1, 4.

¹¹⁵See note 63 *supra*.

¹¹⁶*Sindell v. Abbott Laboratories*, 26 Cal. 3d 588, 611, 607 P.2d 924, 936, 163 Cal. Rptr. 132, 144, *cert. denied*, 449 U.S. 912 (1980).

¹¹⁷Calabresi, *Some Thoughts on Risk Distribution and the Law of Torts*, 70 YALE

by the group which is most likely to cause the burden to be reflected in the price of the product.¹¹⁸

This combination of relative fault and risk distribution renders the market share theory a logically sound and a legally justifiable means of solving the DES causation problem. A theory to allow recovery in asbestos litigation could be justified by this same rationale, if the theory were formulated to take into account the unique aspects of asbestos cases. The theory which this Note proposes combines the underlying rationale of relative fault and risk distribution as set forth in *Sindell* with a means to evaluate the risk created by each asbestos defendant.

A. *The Theory of Product Line Liability*

Product line liability would be available to asbestos plaintiffs who are unable to identify the particular products to which they were exposed. The elements of product line liability, similar to those in *Sindell's* theory of market share liability, consist of the following:

- 1) The plaintiff is not at fault in his inability to identify the particular manufacturers which caused his injury.
- 2) The plaintiff's injury was caused, at least in part, by asbestos exposure which resulted from the risk created by the asbestos industry.
- 3) The joined defendants represent a high percentage of the market for each product line to which the plaintiff was exposed within the relevant geographic markets and during the relevant period of exposure.
- 4) Except for manufacturer identification, the plaintiff has satisfied all of the other elements of the proposed cause of action: negligence, warranty, or strict liability.

Once the plaintiff proves these elements, the burden of proof for causation shifts to the defendants. Each of the defendants can exonerate itself only by a showing that its product line or lines could not have been the ones to which the plaintiff was exposed.

The apportionment of damages among those defendants found liable is determined by a four-step process which takes into account the unique aspects of asbestos litigation. The initial step requires the identification of all the types of asbestos-containing products to

L.J. 499, 505 (1961). For further discussion on loss spreading and risk distribution, see Klemme, *The Enterprise Liability Theory of Torts*, 47 U. COLO. L. REV. 153 (1976) and Calabresi & Hirschhoff, *Toward a Test for Strict Liability in Tort*, 81 YALE L.J. 1055 (1972).

¹¹⁸Calabresi, *supra* note 117, at 505.

which the plaintiff was exposed.¹¹⁹ For instance, the plaintiff may have been exposed to the following types of asbestos products: cloth, board, sectional pipe covering, cement, spray insulation, spray sealant and paint, tile, and friction products. Each of these product lines can be assigned a fiber concentration and emission value which represents the average amount of asbestos fibers released by each product during either the process of fabrication, application, or demolition. These concentrations and emission values are based upon a time-weighted average exposure¹²⁰ and have been measured and quantified by several research groups.¹²¹

By assigning a fiber concentration and emission value to each of the product lines and processes to which the plaintiff was exposed and multiplying by the number of years of exposure, a determination can be made as to the relative risk created by each of the product lines. For example, assume that the plaintiff was exposed to the application of spray insulation for ten years, to cement mixing and application for five years, and to the cutting and installation of sectional pipe covering for two years. The following would represent the relative risk of each of the product line exposures:

Exposures	Emission Value (f/ml)	No. of Years	Extended Value	%Responsibility Assigned to Product Line
Spray insulation	1.5	x 10	= 15	(15/50) 30%
Asbestos cement	5.0	x 5	= 25	(25/50) 50%
Sectional pipe covering	5.0	x 2	= 10	(10/50) 20%
			50	100%

This first step determines the relative propensity of each type of product to create asbestos dust during a particular process. By multiplying the fiber concentration and emission value of each product

¹¹⁹Although a plaintiff may not be able to identify the products to which he was exposed by brand name, the plaintiff generally can remember the types of products to which he was exposed. *E.g.*, Memorandum of Johns-Manville Products Corporation in Opposition to the Plaintiff's Motion to Amend Complaint, at 19, *Neary v. Johns-Manville Prod. Corp.*, No. H78-790 (D. Md., filed May 5, 1978) (plaintiff alleged exposure over decades to molded pipe and block insulation, asbestos cloth, insulating and finishing asbestos cement, asbestos paper, and other asbestos products).

¹²⁰For instance, mixing asbestos cement, which has a very high dust emission value of 50-100 f/ml., is generally only performed for a few minutes once every hour, creating an average concentration factor of 5 f/ml. Selikoff, *The Asbestos Exposure of Insulation Workmen*, INSULATION HYGIENE PROGRESS REP., Spring 1975, 3.

¹²¹*Id.* at 1-4, citing five different studies on asbestos dust concentrations conducted from 1965 through 1971. During the periods of measurement in the 1960's, the work practices were virtually identical to those of prior years and few controls of significance were in use. *Id.* at 3.

and process by the period of exposure, a percentage of responsibility can be assigned to each product line. In the above situation where the plaintiff was exposed to three product lines and processes, the responsibility for the injury caused by asbestos exposure would be allocated as follows: the defendants which manufactured spray insulation would be responsible for thirty percent of the injury caused by asbestos exposure, the defendants which manufactured asbestos cement would be responsible for fifty percent of the injury caused by asbestos exposure, and the defendants which manufactured sectional pipe covering would be responsible for twenty percent.

The second step involves the calculation of responsibility which should be borne by each defendant within each product line. This calculation considers the average market share which each defendant held during the relevant period of exposure and the percentage of asbestos in each defendant's product. Assume that defendants A, B, and C manufactured spray insulation and represent a substantial portion of the spray insulation market during the relevant period of exposure.¹²² Using the example above, assume further that during the ten year period of exposure, manufacturer A controlled an average of sixty percent of the market for spray insulation, and manufacturers B and C controlled an average of thirty percent and ten percent of the spray insulation market, respectively. Using the same rationale as the market share liability theory,¹²³ these market shares would represent the relative responsibility which each of these manufacturers should bear for the damages caused by spray insulation. These market shares, however, must first be adjusted to reflect the percentage of asbestos in each of the different spray insulation products. The calculation would be as follows:

Manufacturer	Average Market Share	% Asbestos in Spray Insulation		Extended Value	% Responsibility in Spray Application
A	60%	x	20%	= .12	(.12/.16) 75.00%
B	30%	x	10%	= .03	(.03/.16) 18.75%
C	10%	x	10%	= .01	(.01/.16) 6.25%
				<u>.16</u>	<u>100.00%</u>

Therefore, manufacturer A would be responsible for seventy-five

¹²²It has been suggested that a substantial percentage of the market should be 75% to 80%. FORDHAM Comment, *supra* note 29, at 996. The higher the percentage of the market that is required to constitute a substantial share, the greater the correlation will be between each defendant's share of the judgment assigned to that product line.

¹²³See note 63 *supra*.

attributable to cigarette smoking.¹²⁵ A failure to consider non-asbestos sources of the plaintiff's injury would result in asbestos manufacturers bearing a greater proportion of the judgment than that for which they are logically responsible.

This latter adjustment may be calculated using statistical data. A recent study indicates that cigarette smoking increases an individual's risk of fatal lung cancer approximately eleven times over that of an individual who does not smoke and has no history of asbestos exposure.¹²⁶ This study also indicates that an individual who both smokes cigarettes and has a history of asbestos exposure increases the risk of fatal lung cancer approximately fifty-three and one fourth times over that of an individual who neither smokes nor has a history of asbestos exposure.¹²⁷ Therefore, it can be determined statistically that approximately twenty percent of the bronchogenic carcinoma and pulmonary fibrosis injuries in smoking asbestos workers should be attributed to cigarette smoking.¹²⁸ The total judgment rendered in favor of a plaintiff then can be adjusted to reflect only those injuries which resulted from asbestos exposure.

B. Further Considerations

There are two considerations worthy of mention with respect to the practical application of the product line liability theory. The first consideration is how to deal with asbestos substitutes in the product line analysis. As mentioned earlier, recent studies indicate that substances such as fibrous glass have the same carcinogenic effect as asbestos fibers.¹²⁹ This evidence suggests that products containing asbestos substitutes should be treated as products containing asbestos under the product line liability analysis.

A second consideration is the effect on product line liability of not being able to join one hundred percent of the market for a particular product line.¹³⁰ Essentially, the question is whether joint and several liability should be imposed on the defendants within

¹²⁵See notes 78-81 *supra* and accompanying text.

¹²⁶See note 80 *supra* for the results of this study. This result was acquired by taking the incidence of fatal lung cancer for cigarette smokers who have no history of asbestos exposure and dividing by the incidence of fatal lung cancer for individuals who do not smoke nor have any history of asbestos exposure. ($122.6 \div 11.3 = 10.8$).

¹²⁷*Id.* This result was acquired by taking the incidence of fatal lung cancer for individuals who have a history of both cigarette smoking and asbestos exposure and dividing by the incidence of fatal lung cancer for individuals who neither smoke nor have any history of asbestos exposure. ($601.6 \div 11.3 = 53.24$).

¹²⁸ $10.8 \div 53.2 = .2$ or 20%.

¹²⁹See notes 73-77 *supra* and accompanying text.

¹³⁰The plaintiff may be unable to assert jurisdiction over the potential defendant, or the defendant may be judgment-proof.

each product line under the product line liability theory. The practical effect of this question is best illustrated by the following hypothetical situation. Assume the five defendants joined by the plaintiff represent only eighty percent of the spray insulation market and that the other twenty percent of the spray insulation market cannot be joined. If joint and several liability is imposed on these five defendants the initial allocation of responsibility within the spray insulation product line would be as follows:

Defendant	Average Market Share	Market Share	
		Percentage ÷ Total Percentage of the Market Represented	Percentage Responsibility
A	40%	40/80	50%
B	20%	20/80	25%
C	10%	10/80	12.5%
D	5%	5/80	6.25%
E	5%	5/80	6.25%
	80%		100%

By imposing joint and several liability where less than one hundred percent of the market is represented, the percentage of responsibility which each defendant bears will be greater than each defendant's market share.¹³¹ Consequently, each defendant would bear a greater share of the liability than that for which it is responsible.

If joint and several liability is not imposed and the market share is used as the basis for calculating each defendant's responsibility, twenty percent of the responsibility for the harm from spray insulation products will remain unsatisfied. Although this approach results in a more equitable allocation of responsibility based upon the relative probability of causation, leaving the plaintiff partially uncompensated with respect to asbestos-related injuries may not be an acceptable result from a policy standpoint. The policy advanced by *Sindell* favors the innocent plaintiff over the defendant manufacturers which created the risk that caused the plaintiff's injury.¹³² Furthermore, *Sindell* stated that the defendants are better able to bear the cost of injury.¹³³ It is unclear, however, whether the market share liability theory in *Sindell* imposes joint and several liability on

¹³¹For an excellent discussion of how this inequitable distribution could be partially readjusted through the use of comparative contribution, see Note, *Industry-Wide Liability and Market Share Allocation of Damages*, 15 GA. L. REV. 423, 440-43 (1981) [hereinafter cited as GEORGIA Note].

¹³²See note 60 *supra* and accompanying text.

¹³³See note 61 *supra* and accompanying text.

the defendants when less than one hundred percent of the market has been joined.¹³⁴

Not allowing joint and several liability under the product line liability theory would create a strong financial incentive for the plaintiff to make every attempt to join as many defendants as possible.¹³⁵ However, the requirement that the plaintiff join a substantial share of the market for each product line identified as a source of the plaintiff's injury provides a similar incentive without placing the burden of not being able to join an insolvent or unamenable defendant on the plaintiff. Under this requirement, the higher the percentage of the market required to constitute a substantial share, the greater the correlation between each defendant's share of the market and its share of the responsibility for the portion of the judgment assigned to the particular product line. With this reasoning and the policies underlying market share liability, joint and several liability should be imposed and a very high percentage of the market for each product line should be required.¹³⁶

C. *Justification for the Imposition of Liability*

When there is no proof that an asbestos manufacturer's product actually caused or contributed to the plaintiff's injury, the imposition of liability on an asbestos manufacturer under a product line liability theory will result in the most equitable solution to the asbestos causation problem. Although such liability would extend the present scope of products liability law, such an extension would not lack historical justification. Product line liability not only finds support under the market share liability theory, but also finds support in the older doctrine of respondeat superior.¹³⁷ The modern justification for the imposition of vicarious liability under the doctrine of respondeat superior is that it "is a rule of policy, a

¹³⁴For conflicting interpretations of this aspect of *Sindell*, see Note, *Beyond Enterprise Liability in DES Cases—Sindell*, 14 IND. L. REV. 695, 721 (1981) and GEORGIA Note, *supra* note 131, at 443-44.

¹³⁵Because a solvent and amenable defendant cannot be held liable for more than his proportionate share, the plaintiff would bear the risk of being unable to collect from insolvent or unamenable defendants. This risk is generally present in most civil suits for damages.

¹³⁶If joint and several liability is imposed under the product line liability theory, the market shares in step two of the apportionment calculation would need to be adjusted to reflect the "adjusted" market share percentages in this phase of the apportionment calculation.

¹³⁷The doctrine of respondeat superior holds a master liable for the torts committed by his servant even though the master is not in privity with the injured party and is innocent of any tortious behavior himself. W. PROSSER, *supra* note 19, § 69 at 458.

deliberate allocation of risk. The losses caused by the torts of the employees, which as a practical matter are sure to occur in the conduct of the employer's enterprise, are placed upon that enterprise itself, as a required cost of doing business."¹³⁸ Likewise, the losses caused by the use of a dangerous ingredient in the products manufactured by an industry should also be placed upon that industry as a cost of doing business where particular manufacturers can not be singled out.¹³⁹ To deny liability in asbestos cases where the plaintiff is unable to identify the actual manufacturers which caused his injury would place the entire risk of loss squarely on the injured plaintiff who can not be faulted for his inability to identify these manufacturers.

From an economic standpoint, asbestos manufacturers did attempt to internalize the potential cost of asbestos-related injuries by purchasing liability insurance and including these insurance premiums in the total cost of the asbestos products. Because asbestos manufacturers and their insurance companies are in the best position to distribute risks as a cost of doing business, policy should favor such distribution regardless of fault, so long as the allocation of losses is accomplished by a logically justifiable means of apportionment. A similar rationale recently formed the basis for the holding in *Keene Corp. v. Insurance Co. of North America*¹⁴⁰ where the court ruled that insurance coverage was triggered at the time of the plaintiff's exposure to the asbestos product and continued through the time when the injury finally manifested itself.¹⁴¹ This decision emphasizes the risk distribution purposes of product liability insurance by holding all prior insurers of Keene Corporation liable regardless of when the plaintiff's injury was detected.

One important aspect of asbestos litigation which differentiates asbestos cases from DES cases and makes them more conducive to a theory that imposes liability on an industry-wide basis is the high probability that the asbestos plaintiff's injury was the result of exposure to a variety of asbestos products which were produced by numerous manufacturers.¹⁴² By imposing liability on the manufacturers of each injury-causing product line, there is a greater possibility that more than one of the asbestos defendants' manufac-

¹³⁸*Id.* at 459.

¹³⁹The purpose of strict liability in tort is to make the industry responsible for harm caused by defective products, allowing the costs to be distributed to the public in the form of higher costs. See RESTATEMENT (SECOND) OF TORTS § 402A, comment c (1965).

¹⁴⁰No. 81-1179 (D.C. Cir. Oct. 1, 1981).

¹⁴¹*Id.*

¹⁴²See note 119 *supra*; Asbestos Comment, *supra* note 8, at 83.

tured products which were the actual cause of the plaintiff's injury. In contrast, the DES plaintiff's mother was generally exposed to only one manufacturer's product; therefore, market share liability, in any one single DES case, imposes liability on numerous defendants that could not have manufactured the particular product which actually caused the plaintiff's injury.

A major concern to both future plaintiffs and defendant manufacturers in asbestos litigation will be whether the asbestos manufacturers and their insurers will be financially capable of fully compensating all of the potential plaintiffs who eventually develop asbestos-related diseases. Eleven million individuals are estimated to have had exposure to significant concentrations of asbestos since 1940.¹⁴³ Last year, the average amount paid to plaintiffs in 395 cases settled out of court was \$76,000.¹⁴⁴ In forty-five asbestos trials which were tried to a verdict, the plaintiffs won twenty-five verdicts ranging from \$16,000 to \$1,857,600.¹⁴⁵ The cost of litigation just on existing cases is estimated to be in excess of \$300,000,000.¹⁴⁶ These figures become even more staggering considering that many asbestos substitutes may cause the same diseases which until recently have been linked only to asbestos. Furthermore, some major asbestos manufacturers are already reaching the limits of their primary insurance.¹⁴⁷

The principle policy underlying the product line liability theory is that the industry is better able to bear the cost of injuries resulting from the use of asbestos products and to distribute such costs to the public as a cost of doing business.¹⁴⁸ The fulfillment of such a policy is critically dependent upon the financial health of the asbestos industry. Therefore, each case should be carefully evaluated to determine the extent of injuries which are related to asbestos exposure and the extent of injuries which are derived from non-asbestos sources. Placing the risk of injuries caused by non-asbestos sources on the asbestos industry may well lead to the industry's inability to bear the cost.

VI. CONCLUSION

Millions of human beings have been or will be affected by what

¹⁴³See note 119 *supra* and accompanying text.

¹⁴⁴Granelli, *The Asbestos Case Explosion*, Nat'l L.J., Oct. 19, 1981, at 24, col. 4.

¹⁴⁵*Id.*

¹⁴⁶*Id.*

¹⁴⁷Levit, *Levit Outlines Catastrophic Product Liability Development*, Nat'l Underwriter, June 19, 1981, at 20, col. 1. Johns-Manville and Raybestos-Manhattan qualified their financial statements for the years 1979 and 1980 due to the ultimate costs of asbestos litigation. *Id.*

¹⁴⁸See notes 137-39 *supra* and accompanying text.

may have become the largest single occupational health problem of our time. Traditional legal theories offer little hope of recovery for the plaintiff who is unable to identify the source of the injury-causing products. Although the market share liability theory, which was designed to overcome the identification problems of DES plaintiffs, is incapable of providing an equitable solution to the asbestos problem, it does provide a sound policy foundation for the imposition of liability in asbestos cases. This Note suggests a theory based upon the rationale of the market share liability theory which is designed to provide an equitable means of apportioning liability among the asbestos manufacturers.

Society faces a choice in asbestos cases in which the plaintiff is unable to identify the particular source of his injury. It can either leave the injury where it falls as the price of modern technology and provide only sporadic compensation through the application of current tort theories, or it can adopt a new legal theory which provides a realistic means of compensating all plaintiffs who suffer from injuries resulting from asbestos exposure. The product line liability theory suggests that the legal system is capable of adjusting to the equities and the economic realities presented by asbestos litigation.

CRAIG A. ETTER

Algorithm Patentability after *Diamond v. Diehr*

I. INTRODUCTION

The explosive growth of computer technology has generated considerable interest in the industry regarding the availability of legal protection for inventions related to computer technology. The field of computer products can be divided into two categories. One category, hardware, consists of the actual physical device.¹ The other category, software, can best be described as the program or programs which cause the hardware to perform its various functions.²

Legal protection for hardware presents little or no problem because it falls squarely within the classification of a "machine" and as such is patentable.³ The question of what protection to afford software, on the other hand, has caused the courts considerable difficulty.

In the software area, part of the problem has been the definition of the term "algorithm." Although a scientific definition of the term would be "a fixed step-by-step procedure for accomplishing a given result,"⁴ the only definition specifically adopted by the Supreme Court has been "[a] procedure for solving a given type of mathematical problem."⁵

The question of patentability of computer controlled processes is another area which has caused courts a great deal of confusion.⁶ The Supreme Court has addressed this question in two recent cases. In *Parker v. Flook*,⁷ the Court denied the patent claim. In a subsequent case, *Diamond v. Diehr*,⁸ the Court allowed the patent for what was arguably the same type of process that was rejected in *Flook*. Furthermore, the *Diehr* case did not resolve the issue of algorithm patentability.

This Note focuses on two aspects of legal protection for computer software and computer based processes. First, the recent Supreme Court decision in *Diamond v. Diehr*⁹ is analyzed to determine the current scope of protection afforded a computer controlled process. Second, the term "algorithm" is examined. The question whether algorithms should be afforded patent protection is addressed,

¹K. McLoughlin, CLARIFYING THE COMPUTER 188 (1967).

²*Id.*

³35 U.S.C. § 101 (1976).

⁴*Diamond v. Diehr*, 450 U.S. 175, 186 n.9 (1981).

⁵*Gottschalk v. Benson*, 409 U.S. 63, 65 (1972).

⁶*See generally* notes 31-104 *infra* and accompanying text.

⁷437 U.S. 584 (1978).

⁸450 U.S. 175 (1981).

⁹*Id.*

and an argument calling for congressional action to provide adequate legal protection for algorithms is developed.

II. HISTORICAL PERSPECTIVE: DEFINITION OF A PROCESS

The most recent comprehensive patent legislation is the Patent Act of 1952.¹⁰ The Patent Act has three sections which define the requirements an invention must meet to be patentable. Section 101 deals with subject matter patentability.¹¹ Section 102 requires that the invention be novel,¹² and section 103 mandates that the invention not be obvious "to a person having ordinary skill in the art to which said subject matter pertains."¹³ In other words, the invention must be non-obvious.

In determining what subject matter is patentable, section 101 of the act reads: "Whoever invents or discovers any new and useful *process* . . . may obtain a patent therefor, subject to the conditions and requirements of this title."¹⁴ Though the language of this section is straightforward, a problem arises regarding the definition and scope of the term "process."

The definition section of the statute states: "The term 'process' means process, art or method, and includes a new use of a known process, machine, manufacture, composition of matter, or material."¹⁵ This statutory definition of a "process" is not significantly different from the language in section 101 dealing with patentable subject matter.¹⁶ Consequently, it provides little guidance in determining what is meant by the term "process."

In the landmark case of *Graham v. John Deere Co.*,¹⁷ the Supreme Court interpreted the effect of the 1952 Patent Act upon the traditional tests of patentability and concluded that the 1952 Patent Act was meant to codify existing judicial precedents.¹⁸ There-

¹⁰Patent Act, ch. 950, 66 Stat. 797 (1952)(current version at 35 U.S.C. §§ 100-376 (1976)). Congressional authority to pass legislation in this area is derived from Article I of the United States Constitution. "The Congress shall have Power To . . . promote the Progress of Science and useful Arts, by securing for limited Times to Authors and Inventors the exclusive Right to their respective Writings and Discoveries." U.S. CONST. art. I, § 8, cl. 8.

¹¹35 U.S.C. § 101 (1976).

¹²*Id.* § 102.

¹³*Id.* § 103.

¹⁴*Id.* § 101 (emphasis added).

¹⁵*Id.* § 100(b).

¹⁶*Id.* § 101.

¹⁷383 U.S. 1 (1966).

¹⁸*Id.* at 3-4. Although the holding in *Graham* was limited to the interpretation of section 103 of the Patent Act, the Court has applied this principle in subsequent decisions dealing with subject matter patentability. See *Diamond v. Diehr*, 450 U.S. at 182; *Parker v. Flook*, 437 U.S. at 588-89; *Gottschalk v. Benson*, 409 U.S. at 67-71.

fore, pre-1952 decisions are relevant to the meaning of the term "process" under the Patent Act and these earlier cases can offer some guidelines for determining the scope of this term. The term "process" was defined in the 1876 case of *Cochrane v. Deener*¹⁹ as follows:

A process is a mode of treatment of certain materials to produce a given result. It is an act, or a series of acts, performed upon the subject-matter to be transformed and reduced to a different state or thing. If new and useful, it is just as patentable as is a piece of machinery. In the language of the patent law, it is an art. . . . The process requires that certain things should be done with certain substances, and in a certain order; but the tools to be used in doing this may be of secondary consequence.²⁰

Thus, an early definition of "process" required a transformation of one tangible substance to another.

The question whether a particular process is patentable subject matter may also be determined by looking to certain subject matters which have been held to be outside the scope of the patent laws. The Supreme Court defined these areas in the 1852 case of *Le Roy v. Tatham*.²¹

It is admitted, that a principle is not patentable. A principle, in the abstract, is a fundamental truth; an original cause; a motive; these cannot be patented, as no one can claim in either of them an exclusive right. Nor can an exclusive right exist to a new power, should one be discovered in addition to those already known.²²

Furthermore, in 1938, the Supreme Court held in *Mackay Radio and Telegraph Co. v. Radio Corp. of America* that a scientific principle or the mathematical expression of it, such as $E = mc^2$, is not patentable.²³

An invention is not automatically rendered unpatentable under section 101, however, simply because it utilizes a scientific principle. "While a scientific truth, or the mathematical expression of it, is not patentable invention, a novel and useful structure created with the aid of knowledge of scientific truth may be."²⁴ As stated by the Court in *Le Roy v. Tatham*: "In all such cases, the processes used to

¹⁹94 U.S. 780 (1876).

²⁰*Id.* at 788.

²¹55 U.S. (14 How.) 155 (1852).

²²*Id.* at 174.

²³306 U.S. 86, 94 (1939).

²⁴*Id.*

extract, modify, and concentrate natural agencies, constitute the invention. The elements of the power exist; the invention is not in discovering them, but in applying them to useful objects."²⁵ Consequently, the Court has upheld patents for the application of physical principles. Such patents include the method for reducing fatty bodies to their component parts through the use of superheated water²⁶ and the use of the Arrhenius equation to improve a process for molding synthetic rubber.²⁷

A related concept in this area of patentable subject matter is the "mental steps" doctrine,²⁸ a process consisting of only mental steps.²⁹ This doctrine was defined in the 1951 pre-computer case of *In re Abrams*.³⁰ The Court of Customs and Patent Appeals (C.C.P.A.) held that certain mental steps, such as registering, measuring, and computing were not patentable even if novel.³¹

The C.C.P.A. repudiated the mental steps doctrine, as set forth in *Abrams*, nineteen years later in *In re Musgrove*.³² In *Musgrove*, the C.C.P.A. held that "[a]ll that is necessary, in our view, to make a sequence of operational steps a statutory 'process' within 35 U.S.C. § 101 is that it be in the technological arts so as to be in consonance with the Constitutional purpose to promote the progress of 'useful arts.'"³³ Thus the interpretation of section 101 in *Musgrove* allows a sequence of steps to be patentable if it satisfies the very low level test of furthering the useful arts.

III. HISTORY OF PATENT PROTECTION FOR COMPUTER SOFTWARE

The United States Patent Office has been in conflict with the C.C.P.A. over the availability of patent protection for computer software since the mid-1960s.³⁴ In 1966, a report by the President's Com-

²⁵55 U.S. (14 How.) at 174.

²⁶*Tilghman v. Proctor*, 102 U.S. 707, 729-30 (1880).

²⁷*Diamond v. Diehr*, 450 U.S. 175 (1981). The Court noted that the Arrhenius equation, a well known equation expressing time, temperature, and cure relationships, "has long been used to calculate the cure time in rubber molding presses." *Id.* at 177, n.2.

²⁸*Davis, Computer Programs and Subject Matter Patentability*, 6 RUT. J. COMP. TECH. L. 1, 8 (1977).

²⁹*Id.*

³⁰188 F.2d 165 (C.C.P.A. 1951).

³¹*Id.* at 170.

³²431 F.2d 882 (C.C.P.A. 1970).

³³*Id.* at 893.

³⁴The prosecution of a patent application may be explained in the following simplified version. A patent application begins with the submission of a patent application to the Patent Office. The Patent Office reviews the application and decides to issue or deny the patent. If the patent is denied, the decision can be appealed to the

mission on the Patent System recommended that computer programs be denied patent protection, primarily because even if adequate classification techniques existed, which they did not, the sheer volume of the prior art would make searches economically infeasible.³⁵ Shortly thereafter, the Patent Office issued a set of guidelines which denied patent protection to computer programs.³⁶ The C.C.P.A. did not accept these guidelines, however, and in *In re Prater*,³⁷ the court affirmed an apparatus claim that involved, in part, a general purpose digital computer programmed to perform the specific function claimed. The Patent Office then withdrew its guidelines.³⁸

The Supreme Court first considered the question of computer program patentability in the 1972 case of *Gottschalk v. Benson*.³⁹ The claimed invention in *Benson* was a technique which converted binary-coded-decimal (BCD) numbers to pure binary numbers. Although the claim specified the manipulation of a re-entrant shift register in a particular manner,⁴⁰ the Court found that the claim was

Patent and Trademark Board of Appeals. An applicant, receiving an adverse decision from the Board of Appeals, can appeal the decision to the Court of Customs and Patent Appeals (C.C.P.A.) or bring a suit against the Patent Commissioner in the Federal District Court for Washington D.C. Procedural differences between the courts may influence the applicant's choice of forum. The primary difference is that the C.C.P.A. review is based entirely upon the record made in the Patent Office, while extrinsic evidence can be brought into the federal district court proceedings. An additional consideration is that no appeal from the C.C.P.A. is available unless the U.S. Supreme Court grants a writ of certiorari, while a suit brought in the federal district court can be appealed by the normal manner. ROSENBERG, PATENT LAW FUNDAMENTALS §§ 15.01-.04 (2d ed. 1980).

³⁵S. Doc. No. 5, 90th Cong., 1st Sess. 12-13 (1967) (the report noted that the lack of patent protection has not prevented a substantial growth in the software industry).

³⁶Examination of Patent Applications on Computer Programs, 33 Fed. Reg. 15609, 15610 (1968) (rescinded 34 Fed. Reg. 15724 (1969)).

³⁷415 F.2d 1393 (C.C.P.A. 1969).

³⁸34 Fed. Reg. 15724 (1969).

³⁹409 U.S. 63 (1972).

⁴⁰*Id.* at 73-74. In the appendix to the Court's opinion, claim "8" reads:

'The method of converting signals from binary coded decimal form into binary which comprises the steps of

- '(1) storing the binary coded decimal signals in a reentrant shift register,
- '(2) shifting the signals to the right by at least three places, until there is a binary '1' in the second position of said register,
- '(3) masking out said binary '1' in said second position of said register,
- '(4) adding a binary '1' to the first position of said register,
- '(5) shifting the signals to the left by two positions,
- '(6) adding a '1' to said first position, and
- '(7) shifting the signals to the right by at least three positions in preparation for a succeeding binary '1' in the second position of said register.'

Id.

actually an algorithm which was equivalent to a mathematical formula.⁴¹ Because mathematical formulas are not patentable subject matter under section 101 of the Patent Act, the Court held the claimed process in *Benson* was "non-statutory" material and thus unpatentable.⁴² The Court in *Benson* did not, however, hold that a computer program was unpatentable per se. The Court stated: "It is said that the decision precludes a patent for any program servicing a computer. We do not so hold."⁴³ Furthermore, the Court stated that it did not intend to "freeze process patents to old technolog[y]."⁴⁴

Because the *Benson* decision did not establish firm guidelines for computer program patentability, the C.C.P.A. soon found ways to limit the scope of *Benson*. In *In re Johnston*,⁴⁵ the C.C.P.A. upheld a patent claim for an automatic financial record keeping system. The court, narrowly construing *Benson*,⁴⁶ stated: "Furthermore, the instant claims, in apparatus form, do not claim or encompass a law of nature, a mathematical formula, or an algorithm. For these reasons, we do not find the holding of *Benson* to be applicable to claims of the type now before us."⁴⁷ Consequently, in subsequent cases the C.C.P.A. limited the *Benson* holding regarding unpatentability to non-apparatus claims,⁴⁸ that is, those claims not involving a specific, physical machine.

The C.C.P.A. also limited the effect of *Benson* by concluding in *In re Freeman* that *Benson* only applied to algorithms which involved a procedure for solving mathematical formulas.⁴⁹ The C.C.P.A. broadened the term "algorithm" by defining it as "'a step-by-step procedure for solving a problem or accomplishing some end.'"⁵⁰ The court then set forth a two-step test in *Freeman* for determining if a claim is pre-empted by the holding in *Benson*:

First, it must be determined whether the claim directly or indirectly recites an 'algorithm' in the *Benson* sense of that

⁴¹*Id.* at 65.

⁴²*Id.* at 71-72.

⁴³*Id.* at 71.

⁴⁴*Id.*

⁴⁵502 F.2d 765 (C.C.P.A. 1974), *rev'd sub nom.* *Dann v. Johnston*, 425 U.S. 219 (1976).

⁴⁶*Id.* at 771.

⁴⁷*Id.* (emphasis deleted). *Johnston* was later overturned, but on section 103 grounds of non-obviousness. The Supreme Court chose not to clarify the *Benson* decision at that time. *Dann v. Johnston*, 425 U.S. 219, 220, 230 (1976).

⁴⁸See, e.g., *In re Noll*, 545 F.2d 141, 148-49 (C.C.P.A.), *cert. denied*, 434 U.S. 875 (1976).

⁴⁹*In re Freeman*, 573 F.2d 1237, 1245 (C.C.P.A. 1978).

⁵⁰*Id.* at 1245 (quoting WEBSTER'S NEW COLLEGIATE DICTIONARY, (1976)).

term, for a claim which fails even to recite an algorithm clearly cannot wholly preempt an algorithm. Second, the claim must be further analyzed to ascertain whether in its entirety it wholly preempts that algorithm.⁵¹

Therefore, for a claim to be pre-empted by the analysis in *Benson*, it must wholly pre-empt a mathematical algorithm which is the same general type as that in *Benson*.

IV. DENIAL OF PATENT PROTECTION FOR A COMPUTER BASED PROCESS

In 1978, the Supreme Court decided *Parker v. Flook*,⁵² which involved a claim for updating alarm limits on any process variable involved in a process comprising the catalytic chemical conversion of hydrocarbons.⁵³ The Court in *Flook* rejected the patent application on section 101 grounds.⁵⁴ Although stating that the claim was a "process" in the ordinary sense of the word,⁵⁵ the Court held that *Benson* precluded a purely literal reading of section 101.⁵⁶ Referring to the *Benson* decision, the Court said, "[t]he question is whether the method described and claimed is a 'process' within the meaning of the Patent Act."⁵⁷ The Court stated that in many cases, the difference between a patentable process and an unpatentable principle can be "seen only by [their] effects when being executed"⁵⁸

The Court analyzed the contention that the presence of specific "post-solution" activity would distinguish the case from *Benson* and make the process patentable. The Court, however, concluded that allowing the presence of post-solution activity to transform an "unpatentable principle into a patentable process exalts form over substance."⁵⁹ According to the Court, a competent draftsman could add post-solution activity to almost any mathematical formula and obtain patent protection for it.⁶⁰

Once the contention regarding "post-solution" activity had been dismissed, the Court turned to the problem of how to analyze a process containing a law of nature or mathematical formula. Referring

⁵¹*Id.*

⁵²437 U.S. 584 (1978).

⁵³*Id.* at 586 (the claim is reproduced in the Appendix to the Opinion of the Court).

⁵⁴*Flook*, 437 U.S. at 588.

⁵⁵*Id.*

⁵⁶*Id.* at 589.

⁵⁷*Id.* at 589 n.10 (quoting *Gottschalk v. Benson*, 409 U.S. 63, 64 (1972)).

⁵⁸*Flook*, 437 U.S. at 589.

⁵⁹*Id.* at 590.

⁶⁰*Id.*

to the cases of *Mackay Radio*⁶¹ and *Funk Bros. Seed Co. v. Kalo Inoculant Co.*,⁶² the Court said:

The process itself, not merely the mathematical algorithm, must be new and useful. Indeed, the novelty of the mathematical algorithm is not a determining factor at all. Whether the algorithm was in fact known or unknown at the time of the claimed invention, . . . it is treated as though it were a familiar part of the prior art.⁶³

Under *Flook*, therefore, an algorithm must be treated as though it were a part of the prior art when the claim is analyzed to determine if it is a patentable invention.⁶⁴

The Court in *Flook* rejected the claimant's argument that this approach improperly imported section 102 and 103 considerations into section 101. The Court held that the fact that a process utilizes a principle in some specific fashion does not automatically cause the process to be patentable subject matter within section 101.⁶⁵ In so holding, the Court emphasized that the underlying basis for the unpatentability of laws of nature was not because natural phenomena are not processes, but because of "the more fundamental understanding that they are not the kind of 'discoveries' that the statute was enacted to protect."⁶⁶

Analyzing the claim at hand, the Court reiterated the principle that a patent claim must be considered as a whole.⁶⁷ Once the Court found the mathematical algorithm was assumed to be within the prior art, the claim contained no patentable invention.⁶⁸

Although not specifically identified by the Court as being a basis for its conclusion, a significant factor in *Flook* was that the mathematical formula was conceded to be the only novel feature of the claimed method.⁶⁹ Once this concession was made, the Court limited itself to the question of whether specific "post-solution" applications of such a formula would render it patentable.⁷⁰ Analogizing the claimed method to patenting the use of the formula for determining the circumference of a circle,⁷¹ the Court concluded that

⁶¹306 U.S. 86 (1939).

⁶²333 U.S. 127 (1948).

⁶³*Flook*, 437 U.S. at 591-92.

⁶⁴*Id.* at 594.

⁶⁵*Id.* at 593.

⁶⁶*Id.*

⁶⁷*Id.* at 594 & n.16.

⁶⁸*Id.*

⁶⁹*Flook*, 437 U.S. at 588.

⁷⁰*Id.* at 585.

⁷¹*Id.* at 595.

the claim in this case was merely for a new mathematical formula and was, therefore, unpatentable.⁷²

V. PATENT PROTECTION GRANTED FOR A COMPUTER BASED PROCESS

Less than three years after *Flook*, the Supreme Court in *Diamond v. Diehr*, found a computer based process for molding synthetic rubber to be patentable subject matter under section 101.⁷³ As a result, *Diehr* has simply added to the growing confusion concerning computer program patentability.

The *Diehr* case involved a claim for "a process for molding raw, uncured synthetic rubber into cured precision products."⁷⁴ The cure time for the process can be calculated by using the Arrhenius equation,⁷⁵ which utilizes well known time, temperature, and cure relationships. Difficulty in accurately computing the cure time resulted from an inability to precisely monitor the temperature of the mold. The claimed technique solved this problem by continuously monitoring the temperature inside the mold cavity and feeding information to a digital computer which repeatedly recalculated the cure time by using the Arrhenius equation.⁷⁶

The Patent and Trademark Office rejected the claim deciding it sought protection for a computer program which was non-statutory material under *Benson*.⁷⁷ The C.C.P.A. reversed, finding that statutory material is not rendered non-statutory merely because a computer is involved.⁷⁸ The C.C.P.A. then held that the claim was patentable because it was directed to an improved process for molding rubber articles, and not to a mathematical algorithm.⁷⁹

The Supreme Court affirmed the decision of the C.C.P.A.⁸⁰ After reviewing the history of the term "process," the majority used the traditional meaning of the term "process," defining it as the transformation of an article to a different state.⁸¹ In reaching this determination, the Court emphasized two factors. First, unless otherwise defined by statute, words will be interpreted according to their normal meaning.⁸² Second, "courts 'should not read into the

⁷²*Id.*

⁷³450 U.S. 175 (1981).

⁷⁴*Id.*

⁷⁵*See id.* at 177 n.2.

⁷⁶*See id.* at 179-80 n.5.

⁷⁷*Id.* (citing *Benson*, 409 U.S. 63).

⁷⁸*In re Diehr*, 602 F.2d 982, 985 (C.C.P.A. 1979).

⁷⁹*Id.* at 988.

⁸⁰*Diamond v. Diehr*, 450 U.S. 175 (1981).

⁸¹*Id.* at 183.

⁸²*Id.* at 182.

The Court based its rejection of the notion that novelty was an appropriate consideration under section 101 on its interpretation of the Patent Act. Because section 102 deals specifically with novelty, the Court affirmed the C.C.P.A.'s position that the question of whether an invention is novel is separate and distinct from the question of whether it is section 101 patentable subject matter.⁹¹

VI. THE *DIEHR* DISSENT

Justice Stevens, writing the dissent, adopted the position of *Flook*. With the exception of Justices White and Powell, the dissenters who joined Justice Stevens in *Diehr* were the members of the majority in *Flook*.⁹²

The dissent began by stating that the position in *Flook* represented the proper approach to section 101.⁹³ It re-emphasized that *Flook* required that the algorithm, for section 101 purposes, be treated as though it were a part of the prior art and the claim then examined "to determine whether it discloses 'some other inventive concept.'"⁹⁴

Following the approach in *Flook*, the dissent interpreted the claim in a different manner than the majority. The majority viewed the claim as involving a new process for curing synthetic rubber.⁹⁵ The dissent, however, dissected the claim. Finding that the claim disclosed nothing new about the physical process of curing synthetic rubber, the dissent concluded that the discovery was for "an improved method of calculating the time that the mold should remain closed during the curing process."⁹⁶

Justice Stevens rejected the majority's conclusion that the claim involved a new method for constantly monitoring the temperature inside the mold.⁹⁷ The dissent pointed out that there was nothing unusual about the particular temperature measuring device used, and that constant temperature measuring devices were commonplace.⁹⁸ Furthermore, the dissent noted that the Board of Patent Appeals had found little difference between well known conventional methods for molding synthetic rubber and the claim in question; the only difference related to the calculation of the curing time through

⁹¹450 U.S. at 189 (citing *In re Bergy*, 596 F.2d 952, 961 (C.C.P.A. 1979)).

⁹²9 FLA. ST. U.L. REV. 381, 391-92 (1981).

⁹³*Diamond v. Diehr*, 450 U.S. at 205 (Stevens, J., dissenting).

⁹⁴*Id.* at 204 (Stevens, J., dissenting) (citing *Parker v. Flook*, 437 U.S. 584, 591-95 (1978)).

⁹⁵*Id.* at 177.

⁹⁶*Id.* at 205-07 (Stevens, J., dissenting).

⁹⁷*Id.* at 207 (Stevens, J., dissenting).

⁹⁸*Id.* at 207-08 (Stevens, J., dissenting).

the use of the mathematical formula.⁹⁹ The dissent therefore concluded that the claim actually involved the use of a digital computer to calculate the time the press should remain closed during the molding process.¹⁰⁰ Using this view, the dissent found that the *Diehr* claims did not differ substantially from the claims in *Flook*.¹⁰¹ The dissent interpreted the claimed discovery in both cases as being an algorithm that could be programmed on a digital computer.¹⁰²

After defining the discovery, Justice Stevens applied the *Flook* analysis to the claim. The dissent reasoned that the majority misapplied *Flook* because the majority failed to distinguish between section 101 and section 102.¹⁰³ The position of the dissent was that the analysis of a patent claim must begin with a determination of whether the claim falls within section 101 patentable subject matter.¹⁰⁴ In this, the relevant issue was whether a new method of programming a digital computer to repeatedly calculate the correct curing time was patentable subject matter.¹⁰⁵ Reviewing the *Benson* and *Flook* positions, the dissent concluded that a method for programming a digital computer was not statutory matter.¹⁰⁶ The dissent then called upon Congress to resolve the question of computer program patentability.¹⁰⁷

VII. COMPUTER BASED PROCESSES: THE SCOPE OF PATENT PROTECTION

The question remaining after *Diehr* involves the scope of the protection to be afforded a computer based process. The *Diehr* dissent's position, which was the majority position in *Flook*,¹⁰⁸ interpreted the patent statutes in a fundamentally different way than the majority in *Diehr*. The conflict centered around the extent to which considerations of novelty and non-obviousness should enter into a determination of what is included in section 101 patentable subject matter.

The majority in *Diehr* interpreted the Patent Act liberally, basing its decision in part upon the landmark case of *Diamond v. Chakrabarty*,¹⁰⁹ in which an artificially produced bacterium was held

⁹⁹*Id.* at 208 (Stevens, J., dissenting).

¹⁰⁰*Id.* at 209 (Stevens, J., dissenting).

¹⁰¹*Id.* at 209-10 (Stevens, J., dissenting).

¹⁰²*Id.* at 209 (Stevens, J., dissenting).

¹⁰³*Id.* at 211 (Stevens, J., dissenting).

¹⁰⁴*Id.* at 212 (Stevens, J., dissenting).

¹⁰⁵*Id.* at 213 (Stevens, J., dissenting).

¹⁰⁶*Id.* at 213-15 (Stevens, J., dissenting).

¹⁰⁷*Id.* at 216-17 (Stevens, J., dissenting).

¹⁰⁸9 FLA. ST. U.L. REV. at 391-92.

¹⁰⁹447 U.S. 303 (1980).

to be patentable subject matter under section 101.¹¹⁰ The Court in *Chakrabarty* interpreted the section 101 provisions as being quite broad: "In choosing such expansive terms as 'manufacture' and 'composition of matter' modified by the comprehensive 'any,' Congress plainly contemplated that the patent laws would be given wide scope."¹¹¹

The *Diehr* majority rejected the notion that section 101 was anything more than a broad, general statement of that subject matter which is eligible for patent protection. In reaching this conclusion, the Court also looked to the reasoning of the C.C.P.A. in interpreting other terms in section 101. In *In re Nelson*, the C.C.P.A. decided the meaning of one condition of section 101—the term "useful."¹¹² The C.C.P.A. quoted with approval the following passages: "[I]t is not the province of the court to go into the question of the extent or degree of usefulness. It is enough that the invention is useful; how useful it may be is immaterial."¹¹³ The court added, "[a]s to the term 'useful,' the courts have construed the condition expressed by it so liberally that it almost never serves to defeat a patent."¹¹⁴ This liberal construction of the term "useful" lends support to an equally liberal construction of the other condition of section 101—the term "new".

The majority in *Diehr* adopted a liberal construction of the term when it held that section 101 was a general statement of subject matter patentability and that novelty played no part in the section 101 determination. The dissent, however, interpreted the Patent Act in a narrower manner. It dissected the claim to determine what part of it was actually new.¹¹⁵ If that part was not eligible under section 101, the entire claim fell.¹¹⁶

The flaw in the dissent's position was that by dissecting the claim and singling out the method of calculation as the actual claimed invention, the dissent ignored the fact that the claim could also be for a new, improved process for molding synthetic rubber. By failing to construe the claim in this manner, the dissent ignored familiar principles of patent law that have been long applied to combination patents.

The Supreme Court established a definition of a combination pat-

¹¹⁰*Id.* at 310.

¹¹¹*Diamond v. Chakrabarty*, 447 U.S. at 308.

¹¹²280 F.2d 172 (C.C.P.A. 1960).

¹¹³*Id.* at 179 (emphasis omitted) (quoting PHILLIPS, THE LAW OF PATENTS FOR INVENTIONS 142 (1837)).

¹¹⁴*In re Nelson*, 280 F.2d at 179 (quoting H.C. MERWIN, PATENTABILITY OF INVENTIONS 75 (1883)).

¹¹⁵*Diamond v. Diehr*, 450 U.S. at 204 (Stevens, J., dissenting).

¹¹⁶*Id.* at 212 (Stevens, J., dissenting).

ent in the 1873 case of *Hails v. Van Wormer*:¹¹⁷ "It must be conceded that a new combination, if it produces new and useful results, is patentable, though all the constituents of the combination were well known and in common use before the combination was made."¹¹⁸ In other words, the combination of old, unpatentable devices may be patentable if the result achieved is new and useful and meets the other requirements of the Patent Act.¹¹⁹ The Court applied this principle in *Diehr* and found that the computer based process was a new process which consisted of the application of an unpatentable algorithm¹²⁰ to the old process of curing synthetic rubber to arrive at a new, improved process of curing synthetic rubber.¹²¹ This interpretation is clearly consistent with the spirit of the Patent Act which permits combination patents. As the majority noted:

It is inappropriate to dissect the claims into old and new elements and then to ignore the presence of the old elements in the analysis. This is particularly true in a process claim because a new combination of steps in a process may be patentable even though all the constituents of the combination were well known and in common use before the combination was made.¹²²

The decision in *Diehr* leaves no doubt that a new and useful process will not be considered unpatentable subject matter merely because it utilizes an algorithm implemented with a digital computer. *Diehr*, however, is directed toward a claim for a process. It neatly avoided the issue of computer program patentability per se.

VIII. ALGORITHM PATENTABILITY

Before answering the question whether an algorithm is patentable subject matter under section 101, the term "algorithm" must be defined. To date, the only definition the Supreme Court has adopted is "[a] procedure for solving a given type of mathematical problem."¹²³ As the Court itself recognized in *Diehr*, however, this is a narrow definition of the term.¹²⁴ The majority noted that a broader

¹¹⁷87 U.S. (20 Wall.) 353 (1873).

¹¹⁸*Id.* at 368.

¹¹⁹*Gruendler Crusher v. Williams Patent Crusher*, 496 F. Supp. 1385 (E.D. Mo. 1980); *Egley v. United States*, 576 F.2d 309 (C.C.P.A. 1978).

¹²⁰According to *Flook*, an algorithm must be treated as part of the familiar art and is, therefore, unpatentable. 437 U.S. at 591-92. *But see* notes 123-51 *infra* and accompanying text.

¹²¹450 U.S. at 188.

¹²²*Id.*

¹²³*Gottschalk v. Benson*, 409 U.S. at 65.

¹²⁴450 U.S. at 186 n.9.

and more scientific definition of the term "algorithm" would be "[a] fixed step-by-step procedure for accomplishing a given result."¹²⁵ Whether this type of algorithm would be patentable was left unresolved by *Diehr*.¹²⁶

Adopting the broader definition, it is apparent that the algorithm itself must be analyzed to determine whether it is patentable subject matter. Should the algorithm involve only a procedure for solving a mathematical formula, it is clearly not patentable subject matter.¹²⁷ An algorithm, however, could also be the step-by-step sequence needed to implement a process and thus be patentable subject matter.

A. *The Algorithm for a Computer Based Process*

An example of the broader definition of an algorithm can be constructed using the *Diehr* claims. Assume that the process for molding synthetic rubber was not an old, established process, but that the claimants had just developed it. Assume also that the process was implemented by using a digital computer to control the entire molding sequence. In this setting, the algorithm which defined the computer program would also define the molding process. Consequently, if patent protection were afforded the newly developed process, which is clearly proper, the algorithm also would be protected.

This example illustrates the holding in *Diehr*; under the broader definition, the algorithm simply defined the process claimed in *Diehr*. Patent protection is afforded the claimed process. The fact that the algorithm was implemented using a digital computer did not render the claimed process unpatentable subject matter. It must be noted that the term "algorithm" in the hypothetical defines the entire claimed process. It is not the algorithm discussed by the Court in *Diehr*, which was limited to the solution of the Arrhenius equation.¹²⁸ This approach, however, still leaves unresolved the problem of whether an algorithm defining a technique which is of use only in a digital computer program is patentable. Although not directly addressed, the position taken by the dissent in *Diehr* indicates that they would deny patent protection for this type of algorithm.

B. *Algorithms Limited to Programming Techniques*

Gottschalk v. Benson can be used to illustrate the problem in this area. In *Benson*, the Court properly found the conversion of a

¹²⁵*Id.*

¹²⁶*Id.*

¹²⁷409 U.S. at 71-72.

¹²⁸*Diamond v. Diehr*, 450 U.S. at 177.

binary-coded-decimal (BCD) number to a pure binary number involves the solution of a mathematical relationship.¹²⁹ The claim in *Benson*, however, involved a specific technique for the solution of this relationship. The technique utilized the manipulation of the registers of a computer in a unique manner.¹³⁰ If the claimants had used electronic hardware to implement their conversion technique, the invention clearly would have qualified under section 101 as a new and useful machine.

This might be the critical distinction for section 101 purposes. An electronic device which implements the algorithm is patentable because it qualifies for patent protection in and of itself as a new and useful "machine." The use of a digital computer to implement the algorithm, however, does not qualify for protection in and of itself because a digital computer is an old device, and the program itself does not qualify under section 101.¹³¹

C. The Claim: Form or Substance

The *Diehr* dissent, when comparing *Flook* with *Diehr*, reasoned that the claims were fundamentally similar and that allowing protection to *Diehr* while denying it to *Flook* made the issue of subject matter patentability turn upon the drafting of the claim.¹³² In other words, it exalted form over substance.¹³³

In a patent, however, it is the claim which defines the scope of the protection.¹³⁴ In this respect, the claims in both *Flook* and *Diehr*, although substantially equivalent in the end result, were clearly different in the protection afforded under a patent. In *Flook*, the claim was for a method of updating alarm limits. Although the claim referred to a specific process, the catalytic conversion of hydrocarbons,¹³⁵ the phrasing of the claim made it clear to the majority that the claim was actually for the discovery of a new mathematical formula with certain post-solution activity included.¹³⁶ Therefore, the protection afforded would be for the mathematical formula. This result is clearly counter to accepted notions of what is patentable subject matter under section 101.

¹²⁹Gottschalk v. Benson, 409 U.S. at 65.

¹³⁰*Id.* at 73-74 (Appendix to the Opinion of the Court).

¹³¹The *Diehr* Court followed the established definition of a patentable process which is the "[t]ransformation and reduction of an article 'to a different state or thing....'" *Diamond v. Diehr*, 450 U.S. at 184, (quoting *Gottschalk v. Benson*, 409 U.S. at 70).

¹³²*Diamond v. Diehr*, 450 U.S. at 210, n.32; See Novick & Wallenstein, *The Algorithm and Computer Software Patentability: A Scientific View of a Legal Problem*, 7 RUT. J. COMP. TECH. L. 313 (1980); 9 FLA. ST. U.L. REV. at 395.

¹³³*Parker v. Flook*, 437 U.S. at 590.

¹³⁴*Smith v. Snow*, 294 U.S. 1 (1935).

¹³⁵437 U.S. at 596 (Appendix to the Opinion of the Court).

¹³⁶*Id.* at 585.

Diehr, on the other hand, involved a claim for a process for molding synthetic rubber which was improved by the method recited in the claim.¹³⁷ As such, the protection was for the type of process that qualifies under section 101.¹³⁸

It could be argued that this is a distinction without a difference. Yet, the patent laws have been interpreted as providing protection for a tangible thing. With respect to a process, the tangible thing requirement is satisfied by the transformation of an article from one state to another. A claim reciting an improved method of calculation which includes post-solution activity is attempting to obtain protection for an intangible that is outside section 101. A claim for a process that is improved by the application of such an intangible falls within section 101.

The *Flook* claim could be reworded to recite an improved process as did the *Diehr* claim. Similarly, the *Diehr* claim could be reworded to resemble the *Flook* claim.¹³⁹ However, in doing so, even though the methods and techniques involved would not change, the scope of the protection would. The *Flook* claim attempts to protect a method of calculation while the *Diehr* claim protects a process.

The end result of this analysis is that *Diehr* may represent a trap for the unwary draftsman. Yet, this may be proper. The importance of the phrasing of the claims in a patent application cannot be overstated. It is the claims which determine the protection afforded. "The claims 'measure the invention.'"¹⁴⁰

D. The Definition of the Term "Algorithm"

Perhaps the confusion regarding the patentability of an algorithm rests with the courts' conception of the term. The courts have construed the term "algorithm" as something in and of itself to be analyzed under section 101. This is improper. The term "algorithm" is a word of art that is generally used in connection with a digital computer. As Novick and Wallenstein suggest in their article dealing with the patentability of algorithms: "In summary, an algorithm provides a method to proceed with a given task. It represents the breakdown of the task into its most fundamental elements for solution by the employed device."¹⁴¹ Therefore, the question whether algorithms should be afforded patent protection is

¹³⁷450 U.S. at 179 n.5.

¹³⁸*Id.* at 191-93.

¹³⁹*Id.* at 210 n.32 (quoting Blumenthal & Riter, *Statutory or Non-Statutory?: An Analysis of the Patentability of Computer Related Inventions*, 62 J. PAT. OFF. SOC'Y 454, 505-06 (1980)).

¹⁴⁰*General Elec. Co. v. Wabash Appliance Corp.*, 304 U.S. 364, 369 (1938).

¹⁴¹*Patentability of Algorithms*, *supra* note 132, at 335.

irrelevant. The proper question is what type of algorithm should be afforded patent protection.

It has been suggested that there is no real distinction between a computer program which doubles the value of a number supplied by an operator and a machine which doubles the amount of a liquid supplied by an operator.¹⁴² "They are equivalent processes—theoretically the same, but physically operating in different media. To treat these two processes as being dissimilar is to make a meaningless distinction."¹⁴³ Both the computer program and the process do the same thing; that is, double the quantity of an item. This statement, at first glance, appears to ignore an important distinction: the Supreme Court has limited patentable processes to those which transform an article to a different state.¹⁴⁴ The machine-based process clearly qualifies because it operates on a tangible object and transforms it. The computer process, in transforming the value of a number, does not operate on the type of tangible thing which is proper subject matter under section 101.

The context in which this statement is made, however, is important in understanding its meaning. Novick and Wallenstein refer to certain modeling programs used by scientists and engineers to simulate a process on a computer before actually implementing it.¹⁴⁵ To make a distinction between the algorithm used in the modeling program and the algorithm used to implement the process would be meaningless. The modeled process is still directed toward the physical transformation of one thing into another when the process is physically implemented.

The authors suggest that algorithms should be understood as being "'physical' manifestations of ideas."¹⁴⁶ If this approach were adopted, then device-specific algorithms, including those in both *Flook* and *Diehr*, would not be rejected on section 101 grounds.¹⁴⁷ Conversely, those algorithms that are not device-specific would be rejected under section 101.¹⁴⁸

Unfortunately, this analysis is not congruent with the traditional definition of a patentable process. This definition requires that a process transform an article or thing to a different state.¹⁴⁹ In the

¹⁴²*Id.*

¹⁴³*Id.* (citation omitted).

¹⁴⁴450 U.S. at 183-84, (quoting *Gottschalk v. Benson*, 409 U.S. 63, 70 (1972)).

¹⁴⁵*Patentability of Algorithms*, *supra* note 132 at 334, n.177.

¹⁴⁶*Id.* at 338 (citation omitted).

¹⁴⁷*Id.* The authors define a device-specific algorithm as being "the analysis of the desired task in relation to the device employed in the solution. The algorithm must explain the procedure that the device employed will use to execute the given task. Therefore, the device must be an integral part of the patent claim." *Id.* at 339.

¹⁴⁸*Id.* at 338 & n.202.

¹⁴⁹450 U.S. at 183-84.

context in which this definition developed, it is apparent that an article or thing is something that is tangible and not simply a number in a computer.

Consequently, at the present time, only those algorithms which implement traditionally defined processes would qualify for patent protection. Those algorithms which represent only an improved technique for processing information in a digital computer, are not patentable. In addition, under the current Patent Act, it is unlikely that such an improved technique will ever qualify for patent protection.

E. The Case for Algorithm Patentability

Whether an algorithm for an improved method of accomplishing operations performed in a digital computer will ever qualify for patent protection remains for Congress to decide. One problem with the current Patent Act is that the electronics industry cannot be certain that newly developed devices using microprocessors will be eligible for patent protection.

As it has become more available and less expensive, the microprocessor is finding its way into an increasing number of electronic devices. The problem is that a manufacturer who develops an idea and reduces it to practice, utilizing a standard microprocessor with a custom-written program, cannot be sure that his invention will be patentable. The manufacturer who elects to implement his idea with a custom electronic design, however, will not be denied patent protection on section 101 grounds. Yet, the two devices may accomplish exactly the same result and, in some cases, use the same algorithm. The algorithm is merely implemented in a different manner.

The algorithm described in the *Benson* claims could clearly represent the type of innovation and inventiveness that the patent statutes were designed to protect. Although the Court in *Benson* characterized the algorithm as being equivalent to a mathematical formula,¹⁵⁰ the algorithm was actually a technique for manipulating the registers of a digital computer to accomplish the conversion of the BCD number to a binary number. The mathematical formula that this technique implemented would be the conversion of a number in base ten form (decimal) to a number in base two form (binary). Furthermore, the technique did not actually pre-empt the mathematical relationship between the two number systems, but only solved the relationship by using a unique technique of register manipulation.¹⁵¹ In other words, the claimed technique represented only one of a potentially large number of methods for solving the mathe-

¹⁵⁰Gottschalk v. Benson, 409 U.S. 63, 65 (1972).

¹⁵¹See note 40 *supra*.

mational relationships between the two number systems with a digital computer.

It is clear that *Benson*-type inventions can represent the type of innovation that is deserving of patent protection. In keeping with the purpose of the patent laws as set forth in article I of the Constitution, Congress must afford algorithms legal protection.¹⁵²

IX. CONCLUSION

Diamond v. Diehr left the major question of algorithm patentability unresolved. *Diehr* stands for the proposition that a process will not be defined as unpatentable subject matter under section 101 simply because it makes use of an unpatentable algorithm. *Diehr's* importance is its implication that a claim must be drafted to claim patentable subject matter such as an improved process, and not merely an improved method of calculation.

From the decisions to date, it is apparent that algorithms which only provide an improved method of processing information with a digital computer will not be patentable. Furthermore, ideas for electronic devices which are implemented using general purpose microprocessors with custom-written software may or may not be afforded protection. Because these inventions may represent the type of scientific advancement that patent laws are designed to protect, Congress must act to define the type of protection to be afforded the various types of algorithms.

ROLAND A. FULLER III

¹⁵²U.S. CONST. art. I, § 8, cl. 8 ("To promote the Progress of Science and useful Arts. . .").

Trademarks and "Look-Alike" Drugs

I. INTRODUCTION

"Look-alike" drugs are generic products¹ which are identical in size, shape, and color to their brand-name counterparts. The problems created by look-alike drugs have arisen in several cases; however, the equities were such that the courts were never forced to decide specifically whether, absent any fundamental inequality in the products, generic drug manufacturers should be allowed to market products made identical in size, shape, and color to their brand-name counterparts. The recent case of *Ives Laboratories, Inc. v. Darby Drug Co.*,² has crystallized this issue and was heard by the United States Supreme Court during its 1981-1982 term.

The courts, aided by previously existing "anti-substitution" legislation,³ had been able to control the controversy between generic and brand-name drug manufacturers. However, with the majority of states repealing that legislation, coupled with the Food and Drug Administration's (FDA) strong support of generic drug use,⁴ the issue of look-alike drugs has exploded into high-stakes economic warfare. The generic drug companies allege that brand-name manufacturers are trying to block generic products from entering the market by creating monopolies in color combinations which would effectively extend the term of their expired patent under the guise of trademark law.⁵ The brand-name companies

¹A "drug product" is a capsule, tablet, or other dosage form which contains a specific "drug" as the active ingredient. Each drug has both a standard "chemical name" and a "non-proprietary name." The non-proprietary name is usually a shortened version of the chemical name and is often, as in this Note, referred to as the "generic name." REMINGTON'S PHARMACEUTICAL SCIENCE 1308-09 (15th ed. 1975) [hereinafter cited as REMINGTON'S]. A brand name, by contrast, is a name arbitrarily assigned to the drug by a particular manufacturer and is often protected under trademark laws as a trade-mark. As long as a generic and a brand-name product contain the same quantity of the active chemical entity, they are termed generically or chemically equivalent. REMINGTON'S, *supra*, at 1368.

²455 F. Supp. 939 (E.D.N.Y. 1978), *aff'd and remanded*, 601 F.2d 631 (2d Cir. 1979); 488 F. Supp. 394 (E.D.N.Y. 1980), *rev'd and remanded*, 638 F.2d 538 (2d Cir. 1981), *rev'd and remanded sub nom.* Inwood Laboratories, Inc. v. Ives Laboratories, Inc., 50 U.S.L.W. 4592 (1982).

³"Anti-substitution laws" prohibit pharmacists from dispensing any manufacturer's drug product other than the one specifically named on the prescription. See notes 12-17 *infra* and accompanying text.

⁴See BUREAU OF CONSUMER PROTECTION, U.S. FEDERAL TRADE COMM'N, DRUG PRODUCT SELECTION, STAFF REPORT TO FTC 1-44 (1979) [hereinafter cited as FTC REPORT]; Hecht, *Generic Drugs: How Good Are They?*, FDA CONSUMER, Feb. 1978, at 17.

⁵See note 30 *infra*.

respond that they are only trying to prevent the generic companies from unfairly utilizing the innovator's advertising campaigns and to protect the good will they have earned through the promotion and use of their products.

Consumers also have interests in the issues raised by look-alike drugs. Without a means to distinguish between specific drug products, consumers will be unable to determine whether unknown or inferior quality drugs are received. In addition, consumers may fall prey to unscrupulous pharmacists who may easily substitute lower-priced generic products for more expensive brand-name products without the consumer's knowledge. Finally, the use of look-alike products provides an opportunity for the imitation of drugs with high abuse potentials thereby creating the possibility for injury or even death.

This Note will evaluate the methods used to control the look-alike drug problem and the effect of look-alikes upon various interested parties. A discussion of legislative and judicial avenues for controlling the problems will follow. Finally, a possible solution will be proposed which takes into consideration the efficiency of available systems and balances the legitimate interests of the parties.

II. BACKGROUND

For centuries merchants and consumers alike have recognized the importance of being able to differentiate among similar products.⁶ Some goods, such as clothing and raw materials, are easily distinguishable simply by touching them; others, such as perfumes or foods, are recognizable by smelling or tasting. For other goods consumers must rely upon accompanying literature, advertising, or consumer reports. Prescription drug products, however, present a unique situation because consumers have no opportunity to receive first-hand information. They must rely not only upon a physician to prescribe the appropriate medications, but also upon a pharmacist to dispense the correct product. Unlike other goods, drugs are capable of being positively identified only by technical chemical assaying; therefore, strict rules and ethics regulating the prescription and distribution of drugs have been created.⁷

Drugs are distributed from the manufacturers in distinctive packaging and with identifying literature; however, the various drugs reach the ultimate consumer in identical amber vials with

⁶H. TOULMIN, *THE TRADE-MARK ACT OF 1946* 1-2 (1946).

⁷*See, e.g.*, IND. CODE §§ 25-26-13-1 to -29 (Supp. 1981) (laws regulating licensure of pharmacists and pharmacies); *id.* §§ 16-1-28-1 to -5, -7 to -16, -19, -22 (pure food and drug legislation).

only a pharmacist's label affixed. Once a medication is removed from one of these vials, only the product's size, shape, and color can provide any hints to its identity. Although the physical appearance of a drug product can create a presumption of the product's identity, the presumption is valid only as long as the strict regulations governing the manufacture and distribution of drug products remain intact.

A. *Mechanisms Used to Further
Drug Product Identification*

The continuing goal of pharmacy laws and ethics has been to assure the patient that he will receive the medications properly prescribed by his physician and that the drugs he receives are of good quality.⁸ A physician has traditionally had the prerogative not only to prescribe an appropriate drug for his patient, but to identify a particular product and its manufacturer or source as well.⁹ Until recently the modern laws governing pharmacy, in an effort to aid in product identification, required the pharmacist to fill the prescription exactly as it was written by the physician. Forty-nine states, however, have repealed these "anti-substitution" laws¹⁰ and now permit pharmacists to substitute, within specified limits, equivalent products for the drug specified by the physician.¹¹

The role of both anti-substitution and pro-substitution laws in providing the ultimate consumer with a means of identifying drugs will be presented as a framework for analyzing the cases involving

⁸REMINGTON'S, *supra* note 1, at 24.

⁹PHARMACEUTICAL MFRS. ASS'N, THE MEDICATIONS PHYSICIANS PRESCRIBE: WHO SHALL DETERMINE THE SOURCE? 3-4 (1972) [hereinafter cited as PMA]. See Willig, *The Prosubstitution Trend in Modern Pharmacy Law*, 6 U. MICH. J.L. REF. 1, 2 & nn.3 & 4, 20 (1972).

¹⁰Indiana is the only state which has retained its substitution prohibition. *Indiana: The Only State Where RPh's Don't Play a Role in Rx Product Selection*, AM. DRUG-GIST, Dec. 1981, at 34.

¹¹For a discussion of state laws permitting substitution, see McCarey, *Generic Substitution Policy*, 34 FOOD DRUG COSM. L.J. 103 (1979); Ruggieri, *Manufacturers' View of Generic Substitution Legislation*, 34 FOOD DRUG COSM. L.J. 108 (1979); Willig, *supra* note 9; Note, *Consumer Protection and Prescription Drugs: The Generic Substitution Law*, 67 KY. L.J. 384 (1978-1979). See also Dickinson, *Substitution After a Decade: Oh, What a Tangled Web!*, DRUG TOPICS, Mar. 15, 1982, at 45, 46-47.

For a pharmaceutical discussion of these laws, see Goldberg & DeVito, *The Impact of State Generic Drug Substitution Laws*, DRUG THERAPY, Dec. 1981, at 75; *Drug Substitution Laws: A State-by-State Overview*, DRUG THERAPY, Dec. 1979, at 15 [hereinafter cited as *Overview*].

For a medical discussion, see Carr, *Potential Liabilities of Generic Drug Prescribing*, DRUG THERAPY, July 1979 at 99; Coyne, *Fear and Loathing and Generic Drugs*, PRIVATE PRAC., Sept. 1978, at 18; *Substitution: The Doctor's Dilemma*, PRIVATE PRAC., June 1980, at 47-60 (special section) [hereinafter cited as *Doctor's Dilemma*].

look-alike drugs. In addition, a familiarity with fundamental concepts concerning trademark law is necessary for an understanding of the judicial treatment of look-alike drugs.

1. *Anti-Substitution Laws.*—Although drug substitutions were occasionally necessary and tolerated during periods of commercial uncertainty and of war, the first national anti-substitution drug law can be traced back to a thirteenth century German edict.¹² Modern anti-substitution laws promulgated during the early 1950's were the result of a growing concern regarding the increased marketing of drug products of unknown quality whose appearance resembled established products.¹³ In an effort to protect consumers from unethical pharmacists who were "palming off," or substituting cheaper imitations without the knowledge or consent of either the physician or the patient, and to protect the property interests of the innovator or brand-name companies, states passed legislation prohibiting the unauthorized substitution of drug products.¹⁴ The underlying rationale appeared to be that the sanctions¹⁵ imposed by these laws against pharmacists engaging in unauthorized substitution would sufficiently curb the practice. The pharmacist, by virtue of his professional ethics,¹⁶ was trusted to refrain from illegal substitution. These laws and the pharmacist's ethics were the only means by which the patient, or ultimate consumer, could be assured

¹²According to an edict issued in 1227 by Emperor Frederic II of Germany, a substitution without the physician's consent would result in a confiscation of all the pharmacist's wares. PMA, *supra* note 9, at 3.

¹³Green, *Welfare Losses from Monopoly in the Drug Industry: The Oklahoma "Anti-Substitution" Law*, 6 ANTITRUST L. & ECON. REV. 97, 108 (1972); Note, *supra* note 11, at 389.

¹⁴See PMA, *supra* note 9, at 5-7.

¹⁵See, e.g., IND. CODE § 25-26-13-26.1(e) (Supp. 1981). One commentator has noted that:

When the consumer reposes a high level of trust and confidence in the expertise of a provider of goods and services, the law commonly treats this vendor in a fashion different from the manner in which it treats other suppliers of goods and services. Accordingly, the law regulates the professions to a greater extent than other occupations. This scrutiny stems largely from the inability of the public to protect itself adequately in a situation where its members engage the professional on the understanding that he will put their interests before his own. Because the professional is deemed to be a fiduciary, the rule of caveat emptor does not apply. This is clearly the case with the professional pharmacist. He stands as a fiduciary for most transactions, and particularly in the case of prescription drugs, the public must trust the ability of the pharmacist to dispense properly those commodities on which health and life may depend.

Willig, *supra* note 9, at 1.

¹⁶AM. PHARMACEUTICAL ASS'N, CODE OF ETHICS (1969), reprinted in REMINGTON'S, *supra* note 1, at 23.

of the drug product's identity because of the inherent difficulty in identifying a drug. The consumer had to believe the drug was what the pharmacist labeled it to be, otherwise he would always have to have it assayed. If look-alike products were available, the faith in the pharmacist had to be well-founded.

The sanctions imposed by the anti-substitution laws impressed upon pharmacists the magnitude of their ethical responsibilities to consumers. In addition, they imposed a standard of conduct which resulted in a high degree of predictability with respect to substitution and similar products. As long as the anti-substitution laws were in effect, *any* substitution of drug products without the physician's knowledge or consent was illegal. The patient could, thereby, reasonably rely on the pharmacist to dispense the specific product ordered by his physician without fear of an unauthorized substitution occurring.

2. *Pro-Substitution Laws*.—In the 1970's, however, a strong, and ultimately successful, movement to reverse the traditional anti-substitution attitude began to gain momentum.¹⁷ As patents held by research-oriented drug manufacturers expired, large numbers of cheaper, generic drug products became increasingly available.¹⁸ Because of the nature of the advertising strategies of the two types of drug companies,¹⁹ the brand-name companies appeared to have a substantial marketing advantage over the generic drug manufacturers.²⁰ This resulted in an alleged inability of the lower priced generic products²¹ to break competitively into the market unless substitution was allowed, thus depriving the consumer of the opportunity to receive cheaper medications.²²

¹⁷See *Generic Deceit: "Look-alike" Drugs and Your Patients*, PRIVATE PRAC., May 1978, at 61, 63. See generally note 11 *supra*.

¹⁸See FTC REPORT, *supra* note 4, at 43-45.

¹⁹See *id.* at 44-50. For a comparison of the differing approaches used by the companies, see notes 50-62 *infra* and accompanying text.

²⁰See, e.g., *Pennwalt Corp. v. Zenith Laboratories, Inc.*, 472 F. Supp. 413, 421 (E.D. Mich. 1979); Green, *supra* note 16, at 102; Latiolais, *Should the Anti-Substitution Laws Be Amended to Permit Substitution? Yes!*, PHARM. TIMES, Sept. 1972, at 32; Stetler, *Should the Anti-Substitution Laws Be Amended to Permit Substitution? No!*, PHARM. TIMES, Sept. 1972, at 33; *Look-Alike Drugs: Is This Pharmacy's Next Battle Ground?*, DRUG TOPICS, Sept. 4, 1979, at 6.

²¹Generic products are generally less expensive than their brand-name counterparts, primarily for three reasons: (1) generic drug manufacturers have no research and development costs to recoup; (2) they advertise products on a "product line" concept rather than individually promoting drugs; and, (3) they adhere primarily to minimum FDA quality control standards. See THE PHARMACEUTICAL INDUSTRY 87 (C. Lindsay ed. 1978); FTC REPORT, *supra* note 4, at 44-50. See also notes 46-62 *infra* and accompanying text.

²²But as with other commodities, a cheaper product is not always better than, or even equivalent to, similar goods. The added expense often covers the cost of increased quality. See *Brand vs. Generic Names*, 59 J. IND. ST. MED. A. 914 (1966) (editorial).

In asserting their position, proponents of substitution pointed to ongoing scientific developments as providing a rational basis for a reversal in policy. They asserted that the fear of unknown or inferior products was no longer valid in light of: (1) the increased regulation and control of drug production by the federal government and, (2) the increased training received by pharmacists which enables them to evaluate data concerning various drug products and to choose among safe and comparable products.²³ Based upon this rationale, the anti-substitution laws were repealed by all but one state,²⁴ and new laws permitting drug substitution within specified limitations were passed.²⁵

With the restraints of anti-substitution laws removed, the presumption that the drug received is the specific drug product ordered becomes weaker. Although the pharmacist is still restricted to substituting only generic equivalents,²⁶ there are many other factors affecting the specific drug products which may or may not be equivalent.²⁷ For this reason it becomes important that the consumer actively monitors the particular drug product which he receives. Without the strong presumption that the drug product is indeed the one specified by the prescription, the consumer must rely more than

²³Tyler, *Are Generics a Drug on the Market?*, 70 J. IND. ST. MED. A. 452, 454-55 (1980). The validity of these bases has been challenged and is the focus of the raging debate concerning substitution. See, e.g., Berger, *Drug Product Selection: Are All Drugs Created Equal?*, MED. MKTG. & MEDIA, Sept. 1980, at 46; Coyne, *Substitution or Switching? New Name For An Old Game*, PRIVATE PRAC., Oct. 1981, at 22-26; Davis, *Brand vs. Generic Drugs*, MED. MKTG. & MEDIA, May 1979, at 4; Dickinson, *supra* note 11, at 45; Feldmann, *Drug Product Selection—Freedom with Responsibility*, 12 J. AM. PHARM. A. (n.s.) 368 (1972); Latiolais, *supra* note 20, at 36; Stetler, *supra* note 20, at 33; *Doctor's Dilemma*, *supra* note 11, at 47-60; *Look-Alikes Can Be Trouble For All, Lawyer Says*, DRUG TOPICS, June 19, 1981, at 16-17. See also *Generic Deceit*, *supra* note 17, at 61, 63.

²⁴See note 10 *supra*; see also *Overview*, *supra* note 11, at 15.

²⁵The New York substitution law is exemplary of common substitution limitations. The physician signs the prescription on a line indicating permission for the pharmacist to substitute or not. N.Y. EDUC. LAW § 6810(6)(a) (McKinney Supp. 1981-1982). If permission to substitute is indicated, the pharmacist must select a less expensive drug product equivalent in form and dosage to the one originally prescribed. *Id.* § 6816-a(1). Often the pharmacist is required to select the product from a list specially prepared by the state. See, e.g., N.Y. PUB. HEALTH LAW § 206(1)(o) (McKinney Supp. 1981-1982). Unfortunately, cost is often the paramount criterion used to compose these lists. Tyler, *supra* note 23, at 455.

²⁶See note 1 *supra*.

²⁷Many factors are involved in the manufacture of drug products and each factor has the potential to alter the amount of actual drug which is made available to the body. For a complete discussion of these variables and their potential effects, see REMINGTON'S, *supra* note 1, at 1355-435. For a brief overview, see *Generic Deceit*, *supra* note 17, at 64.

ever on the physical appearance of the dispensed medication, the only information available to him.

It appears that the opportunity to receive less expensive drug products has shifted more responsibility onto the consumer to recognize the drug products he receives. This, in turn, should require the drug manufacturers to sufficiently distinguish their similar products in order to enable the consumer to aid the pharmacist in dispensing the same product as previously received. A degree of predictability has been lost in primarily two aspects when look-alike products are also involved because questions remain whether the specific drug product dispensed is indeed what it is labeled to be, and whether the drug dispensed was the exact product specified by the physician.

3. *Trademark Theories and Policies.*—Although the specific laws regulating trademarks developed slowly, various marks have been used since antiquity to designate the source or ownership of particular goods.²⁸ Today, trademarks serve primarily three functions: (1) as a means of assuring the consumer of a continuity of quality; (2) as a means of identifying a product's source or origin and thus distinguishing between competing products; and, (3) as a means of advertising.²⁹

Because of the fear of creating monopolies, however, these laws have always limited the scope of what can be trademarked.³⁰ In

²⁸See McClure, *Trademarks and Unfair Competition: A Critical History of Legal Thought*, 69 TRADEMARK REP. 305, 310-16 (1979). For a full discussion of early trademark history, see Diamond, *The Historical Development of Trade-marks*, 65 TRADEMARK REP. 265 (1965); Paster, *Trademarks—Their Early History* (pt. 1), 59 TRADEMARK REP. 551 (1969); Ruston, *On the Origin of Trademarks*, 45 TRADEMARK REP. 127 (1955). For a discussion of early American trademark history, see Pattishall, *Two Hundred Years of American Trademark Law*, 68 TRADEMARK REP. 121 (1978).

²⁹J. CALIMAFDE, TRADEMARKS AND UNFAIR COMPETITION 1 (1970); Diamond, *supra* note 28, at 289; Lunsford, *The Function of Trademarks in the Market Place*, 64 TRADEMARK REP. 75, 78 (1974).

³⁰See McClure, *supra* note 28, at 1.

At first blush, the decisions of *Sears, Roebuck & Co. v. Stiffel, Co.*, 376 U.S. 225 (1964), and *Compco Corp. v. Day-Brite Lighting, Inc.*, 376 U.S. 334 (1964), appeared destined to grossly restrict state regulation of industrial property through unfair competition laws. See G. ALEXANDER, COMMERCIAL TORTS § 1.4 (1972); Handler, *Product Simulation: A Right or a Wrong? (Symposium)*, 64 COLUM. L. REV. 1183, 1184 (1964). More importantly, these cases appeared to restrict the application of federal trademark law to products which were the subject of an invalid or expired patent. See Kestenbaum, *The Sears and Compco Cases: A Federal Right to Compete by Copying*, 51 A.B.A. J. 935, 939 (1965); Spratling, *The Protectability of Package, Container and Product Configurations*, 63 TRADEMARK REP. 117, 133-34 (1973); Comment, *The Impact of Sears and Compco on Federal Trademark and Patent Law*, 19 BUFFALO L. REV. 91, 95-96 (1970).

The Supreme Court has, however, subsequently held that trademark principles

order to be a trademark, the identifying mark must be in continual use and capable of identifying the product.³¹ A mark which is neither distinctive nor arbitrary but is merely descriptive must also have acquired secondary meaning in the minds of the public; the public must associate the mark as representing goods from a particular, albeit anonymous, source.³² Whether a mark has acquired a secondary meaning in the public mind is always a question of fact.³³ Because of the difficulty in discerning the "public's mind," courts have generally considered three factors in determining the acquisition of secondary meaning: (1) the length of time the mark has been in use; (2) the expense and extent of promotional advertising; and, (3) the product's sale volume.³⁴

If the mark is "primarily descriptive of the qualities, ingredients, or characteristics" of the product, however, it will not be protected as a trademark because it is a "functional" feature.³⁵ For example, in *William R. Warner & Co. v. Eli Lilly & Co.*,³⁶ the plaintiff was unable to prevent competitors from marketing imitative chocolate-flavored quinine syrups. The Court held that the chocolate flavoring

and patent principles are directed at different purposes and thus one is not limited by the other. *Kewanee Oil Co. v. Bicron Corp.*, 416 U.S. 470, 491-93 (1974). *See also* *Truck Equip. Serv. Co. v. Fruehauf Corp.*, 536 F.2d 1210, 1215 (8th Cir.), *cert. denied*, 429 U.S. 861 (1976) ("Full and fair competition requires that those who invest time, money and energy into the development of goodwill and a favorable reputation be allowed to reap the advantages of their investments."); *In re Mogen David Wine Corp.*, 372 F.2d 539 (C.C.P.A. 1967) (Mogen David II); *In re Mogen David Wine Corp.*, 328 F.2d 925 (C.C.P.A. 1964) (Mogen David I); *In re Deister Concentrator Co.*, 289 F.2d 496 (C.C.P.A. 1961).

For a more thorough examination of the *Sears-Compco* doctrine, see Dannay, *The Sears-Compco Doctrine Today: Trademarks and Unfair Competition*, 67 TRADEMARK REP. 132 (1977); Zammitt, *The Ghost of Sears-Compco is Finally Laid to Rest Or Is It?*, 3 HOFSTRA L. REV. 37 (1975); Note, *Generic Drug Laws and Unfair Competition Claims Under the Lanham Act—An Uneasy Alliance*: *Ives Laboratories, Inc. v. Darby Drug Co.*, 33 RUTGERS L. REV. 227, 240-44 (1980).

³¹J. CALIMAFDE, *supra* note 29, at 1.

³²E. VANDENBURGH, TRADEMARK LAW AND PROCEDURE 119-23 (1968 & Supp. 1978); *Tas-T-Nut Co. v. Variety Nut & Date Co.*, 245 F.2d 3 (6th Cir. 1957). The term "secondary meaning" is actually a misnomer because it "does not mean a subordinate or rare significance. It means rather a subsequent significance added to the previous meaning of the designation and becoming in the market its usual and primary significance." RESTATEMENT OF TORTS § 716, comment b (1938).

³³J. CALIMAFDE, *supra* note 29, at 102.

³⁴*Id. See, e.g.,* *SK&F, Co. v. Premo Pharmaceutical Laboratories, Inc.*, 625 F.2d 1055 (3d Cir. 1980) (sales volume); *Barton v. Rex-Oil Co.*, 2 F.2d 402 (3d Cir. 1924) (length of time); *Le Blume Import Co. v. Coty, Inc.*, 293 F. 344 (2d Cir. 1923) (advertising expenses).

³⁵R. CALLMANN, 3 THE LAW OF UNFAIR COMPETITION, TRADEMARKS, AND MONOPOLIES § 70.1 (3d ed. 1969 & Supp. 1981).

³⁶265 U.S. 526 (1924).

was a functional feature of the syrup because it masked the bitter taste of the quinine, and therefore did not "merely serve the incidental use of identifying the . . . preparation."³⁷

In order to be protectable as a trademark, the identifying feature, therefore, must be both nonessential to the product and capable of being associated with the product in the public's mind. Justice Frankfurter summarized and explained the qualifications and relationships of trademarks as follows:

A trade-mark is a merchandising short-cut which induces a purchaser to select what he wants, or what he has been led to believe he wants. The owner of a mark exploits this human propensity by making every effort to impregnate the atmosphere of the market with the drawing power of a congenial symbol. Whatever the means employed, the aim is the same—to convey through the mark, in the minds of potential customers, the desirability of the commodity upon which it appears. Once this is attained, the trade-mark owner has something of value. If another poaches upon the commercial magnetism of the symbol he has created, the owner can obtain legal redress.³⁸

These requirements have caused the development of two closely related causes of action which differ primarily in the number of steps necessary to prove the existence of a trademark.³⁹ Section 32 of the Lanham Act embodies the common law test for true trademark infringement—"likely to cause confusion, or to cause mistake, or to deceive"⁴⁰—and is applicable in cases involving registered trademarks.⁴¹ Section 43(a) of the Lanham Act⁴² encompasses the broader category of unfair competition which includes actions for palming off and "unprivileged imitation."⁴³ In addition to proving the "likelihood of confusion," section 43(a) requires a

³⁷*Id.* at 531. For an argument that the use of chocolate flavoring should have been classified as nonfunctional, see Cooper, *Trademark Aspects of Pharmaceutical Product Design*, 70 TRADEMARK REP. 1, 9-11 (1980).

³⁸*Mishawaka Rubber & Woolen Mfg. Co. v. S.S. Kresge Co.*, 316 U.S. 203, 205 (1942).

³⁹*McClure*, *supra* note 28, at 314.

⁴⁰15 U.S.C. § 1114(1)(a) (1976). See *Sears, Roebuck & Co. v. All States Life Ins. Co.*, 246 F.2d 161 (5th Cir.) *cert. denied*, 355 U.S. 894 (1957); *Ciba Pharmaceutical Prods., Inc. v. Abbott Laboratories*, 121 F.2d 551 (C.C.P.A. 1941).

⁴¹15 U.S.C. § 1114(1)(a) (1976).

⁴²*Id.* § 1125(a).

⁴³See, e.g., *SK&F, Co. v. Premo Pharmaceutical Laboratories, Inc.*, 625 F.2d 1055 (3d Cir. 1980).

preliminary step of proving secondary meaning.⁴⁴ This prerequisite step is not necessary under section 32 because the registration of the mark creates a mandatory presumption of its secondary meaning. Section 43(a) is not limited to actions alleging infringement of unregistered trademarks, but also includes false advertising and false descriptions of products.⁴⁵

B. *The Parties' Interests*

The goal of both pharmacy laws concerning substitution and trademark laws is to protect the valid interests of as many concerned parties as possible. To understand the depth of the look-alike controversy, it is necessary to examine in more detail the various interests of the parties concerned. Because the more blatant economic effects are present at the manufacturers' level, the controversy is more sharply focused there. Nevertheless, the issue has significant effects on both distributing professionals and ultimate consumers.

1. *Manufacturers.*—The look-alike issue affects two types of drug manufacturers: brand-name, or innovator, companies which, through extensive research and development, introduce new patented drugs into the market;⁴⁶ and generic companies, which offer their products only after the brand-name companies' patents have expired. Although both parties have economic interests to safeguard, the law protects those interests only to a limited extent through the use of patents,⁴⁷ trademarks,⁴⁸ and general anti-trust principles.⁴⁹

Brand-name companies have an economic interest in protecting their investment of time and money in researching products. A 1979 FTC staff report⁵⁰ stated that drug companies not only finance their

⁴⁴See Note, *Generic Drug Laws and Unfair Competition Claims Under the Lanham Act—An Uneasy Alliance: Ives Laboratories, Inc. v. Darby Drug Co.*, 33 RUTGERS L. REV. 227, 235-38 (1980). If the mark is, however, purely arbitrary and has no descriptive property, secondary meaning is inherently present. See 3 R. CALLMANN, *supra* note 35, at § 71.4.

⁴⁵15 U.S.C. § 1125(a) (1976).

⁴⁶These manufacturers continue to market the drug even after the patent has expired, of course. In addition, some brand-name manufacturers also market various generic products. See FTC REPORT, *supra* note 4, at 48-49.

⁴⁷35 U.S.C. §§ 101-171 (1976). Patents, with the exception of design patents, are issued for periods of 17 years. Design patents are issued for the terms of 3½, 7, or 14 years, depending upon the election of the applicant. *Id.* §§ 154, 173.

⁴⁸Lanham Act of 1946, 15 U.S.C. §§ 1051-1127 (1976).

⁴⁹Sherman Act, 15 U.S.C. §§ 1-7 (1976); Clayton Act, 15 U.S.C. §§ 12-27. See McClure, *supra* note 28.

⁵⁰FTC REPORT, *supra* note 4.

own research almost exclusively, but spend more money on research and development than any other industry.⁵¹ The estimated cost of pharmaceutical research is fifty million dollars for each drug actually marketed after its approval by the FDA.⁵² Because the research and development process of the drug industry is internally funded, these dollars must be recouped if new drugs are to continue to be discovered and marketed.⁵³

Once the new drug is actually marketed, the brand-name company generally has only eight or nine remaining years of its patent-created monopoly.⁵⁴ In order to recover their costs within this period of time, the innovator companies spend large amounts of money in advertising and promoting their products.⁵⁵ Those companies typically employ large forces of "detail men" to deal directly with physicians, hospitals, and pharmacists, providing both promotional and informative literature regarding the products' physical and pharmacological attributes and properties.⁵⁶ Brand-name companies also advertise extensively in medical and pharmaceutical journals.⁵⁷ Those promotional activities not only serve an economic function as advertising, but are relied upon by both pharmacists and

⁵¹*Id.* at 22-25. The drug industry spends approximately 12% of its research budget on basic research and development as compared to the aircraft industry which spends less than 1%, and all private industry which spends an average of 3%. *Id.* at 24. Figures from the Pharmaceutical Manufacturers Association show that company-financed research and development was \$50,000,000 in 1951 and increased to \$937,500,000 in 1975. *Id.* at 22.

⁵²*Unapproved Generics*, AM. PHARM. (n.s.) Nov. 1980, at 12, 17. See also Gorrell, *Substitution: Expectations and Realizations*, MED. MKTG. & MEDIA, May 1981, at 54, 57.

⁵³*Large Drug Firms Fight Generic Substitution*, 206 SCI. 1054 (1979). See Cocks, *Economic Competition in the Ethical Pharmaceutical Industry*, TILE & TILL, Winter 1978-1979, at 19, 22; Tyler, *supra* note 23, at 455-57.

⁵⁴Although patent protection is conferred for 17 years, a slow down in the FDA's processing has created an average lag of eight years between the time a new drug is patented to the time it is marketed. This period should be compared to the time lag in patenting and marketing new electronics—eighteen months. *Large Drug Firms Fight Generic Substitution*, 206 SCI. 1054, 1056 (1979). For a discussion of prerequisites to FDA marketing approval for new drugs, see REMINGTON'S, *supra* note 1, at 1300-11.

⁵⁵See, e.g., *Pennwalt Corp. v. Zenith Laboratories, Inc.*, 472 F. Supp. 413, 416 (E.D. Mich. 1979), *appeal dismissed mem.*, 615 F.2d 1362 (6th Cir. 1980) (the plaintiff spent over \$2,000,000 in promoting its product each year since 1971); *Smith, Kline & French Laboratories v. Heart Pharmaceutical Corp.*, 90 F. Supp. 976, 977 (S.D.N.Y. 1950) (the plaintiff spent approximately \$900,000 in promoting the new color and shape of its product).

⁵⁶See *The Pharmaceutical Sales Representative: A Professional Communicator*, TILE & TILL, Summer 1978, at 8.

⁵⁷See, e.g., *Pennwalt Corp.*, 472 F. Supp. at 416; *Smith, Kline & French Laboratories*, 90 F. Supp. at 977; see generally Leffler, *Persuasion or Information? The Economics of Prescription Drug Advertising*, 24 J.L. ECON. 45 (1981).

physicians as an important source of information about new drugs.⁵⁸ Through its advertising and detailing service, a brand-name drug company establishes a reputation for quality products. Because a picture of the product is often featured in the promotional and advertising literature, its physical appearance also becomes easily recognized as an attendant consequence of this process.

The generic companies, on the other hand, offer only unpatented drugs, but can provide them at substantially lower prices.⁵⁹ The generic companies are generally able to offer the consumer lower prices for the following reasons: they do not engage in research and development; they do not engage in "detailing" or individual promotion, but rather promote drugs in "product lines"; and most generic companies adhere only to minimum FDA quality control standards.⁶⁰ Because of the brand-name companies' monopolies during their patent periods, and their extensive advertising and promotional campaigns, the generic companies contend that unless they are allowed to copy the size, color, and shape of brand-name products, they will not be able to break competitively into the market.⁶¹ They also assert that by producing a look-alike, they are promoting emergency identification, as well as making substitution easier for both pharmacists and consumers.⁶²

2. *Professionals.*—Physicians and pharmacists have an interest in product safety, a concern that has two overlapping aspects: a concern for easy identification; and a concern for bioequivalency in substituted products.⁶³

⁵⁸Because of the nature of research within the drug industry, the innovator manufacturer is often the only source of information regarding the uses and precautions, as well as the physical and pharmacological properties of a new drug. Therefore, physicians and pharmacists rely heavily upon the manufacturers, especially for initial information and clinical studies pertaining to the new drug. DRUG DEVELOPMENT AND MARKETING 124, 182-86 (R. Helms ed. 1975).

⁵⁹See FTC REPORT, *supra* note 4, at 44-50.

⁶⁰*Id.* FDA control standards are only minimum standards. See PHARMACEUTICAL MFRS. ASS'N, BRANDS, GENERICS, PRICES AND QUALITY—THE PRESCRIBING DEBATE AFTER A DECADE (1971); Willig, *supra* note 9, at 19-21. For information concerning quality control within drug manufacturing, see generally REMINGTON'S, *supra* note 1, at 519-29. For information from which to derive differences in quality control standards among various manufacturers, see Goldfinger, *Dissimilarities of Digoxin*, 285 NEW ENG. J. MED. 1376 (1971); Lindenbaum, Mellow, Blackstone & Butler, *Variations in Biologic Availability of Digoxin from Four Preparations*, NEW ENG. J. MED. at 1344; Vitti, Banes & Byers, *Bioavailability of Digoxin*, NEW ENG. J. MED. at 1433.

⁶¹See, e.g., *Pennwalt Corp.*, 472 F. Supp. at 421; *Look-Alike Drugs: Is This Pharmacy's Next Battle Ground?*, DRUG TOPICS, Sept. 4, 1979, at 6.

⁶²Letter from Milton A. Bass & George Schwartz, representatives of the National Association of Pharmaceutical Manufacturers, to FDA Commissioner Jere E. Goyan (July 14, 1980).

⁶³The bioequivalence of two drug products is a comparison between the

Distinguishing one drug from another is not always sufficient; often the manufacturer must be known as well. Although many drugs are distinctly colored, others, for various reasons, are not.⁶⁴ Neither physicians nor pharmacists positively identify a tablet or capsule by color alone.⁶⁵ Without additional information, such as the drug's name, the company's name, or distinguishing marks or numbers, it is often impossible to identify a capsule or tablet once it is removed from its bottle or vial.⁶⁶

Look-alike drug products compound this problem. Typically, physicians or pharmacists attempt to match a combination of color and distinguishing marks or numbers with ones presented in the *Physicians' Desk Reference (PDR)*.⁶⁷ However, because many generic companies do not submit monographs to the *PDR*, their products are not easily identifiable.⁶⁸ The fact that their products may be similarly colored to one in the *PDR* is of no real value because many completely different drugs may be look-alikes.⁶⁹

Bioequivalence is the second major safety concern. It is now well established that even though a drug may be chemically equivalent,

bioavailability of the two products. Bioavailability refers to that property of the drug which makes it available to tissues of the body. D. CHODOS & A. DiSANTO, *BASICS OF BIOAVAILABILITY* 16 (1973). "Bioavailability is a concept that is based on the assumption that the measurement of certain specific parameters (usually serially obtained blood or urine concentrations of drugs) following drug administration can be correlated with the clinical efficacy of that drug as evaluated in the therapy of specific disease." *Id.*

⁶⁴Coloring agents are excipients or ingredients other than the active ingredient. These agents may be incompatible, either physically or chemically, with the drug or they may cause undesirable variations in the release rate of the drug. Although excipients are not listed as the active ingredient, they are not necessarily inert. See REMINGTON'S, *supra* note 1, at 1309, 1355-67. For a further discussion of the role of excipients, see A. FISHBURN, *AN INTRODUCTION TO PHARMACEUTICAL FORMULATION* 3-10 (1965).

⁶⁵See, e.g., *SK&F, Co. v. Premo Pharmaceutical Laboratories, Inc.*, 625 F.2d 1055, 1060 (3d Cir. 1980); *Identification Guide for Solid Dosage Forms*, 182 J. A.M.A. 1145 (1962).

⁶⁶Davis, *Exert Your Power to Ensure that Oral Solids are Visually Identifiable*, 14 HOSP. PHARM. 180 (1979) (editorial).

⁶⁷The *PDR* is an annual publication compiling the manufacturers' package inserts for many drugs. It is not a complete compilation, however; many manufacturers choose not to pay the fee to have their drug monographs included. The *PDR* also includes a color pictorial section of a limited number of drugs that serves as a helpful identification guide. See *PHYSICIANS' DESK REFERENCE* (36th ed. 1982) [hereinafter cited as *PDR*]; Jacknowitz, *Survey of the Monogramming of Solid Dosage Forms by the Pharmaceutical Industry*, 14 DRUG INFO. J. 113, 115 (1980).

⁶⁸Jacknowitz, *supra* note 67, at 115.

⁶⁹There are several products, for example, which are currently marketed in maroon and white capsules, but which are totally unrelated therapeutically. For example, Duricef 500 mg. (Mead Johnson & Co.) (antibiotic); Extra-Strength Tylenol (MacNeil Laboratories) (analgesic); Serax 30 mg. (Wyeth Laboratories) (anti-anxiety). *PDR*, *supra* note 67, at 417, 440.

it is not necessarily bioequivalent. The tablet or capsule may contain the same chemical, but it may not be capable of producing the same pharmacological effect at the same rate in the same dosage.⁷⁰ Each manufacturer must develop its own process and formulation of active and inactive ingredients, any of which may alter the product's bioavailability.⁷¹ When an innovator company's patent expires, only the drug itself and not the company's product formulation passes into the public domain.⁷²

Although not all drugs have been demonstrated to show differences in bioavailability, there have been studies that show potential bioavailability problems with seventy-three commonly prescribed drugs.⁷³ Although the comparative bioavailability of the various drug formulations is always important,⁷⁴ there are three instances when bioequivalence becomes critical to effective therapy: (1) when the drug has a low therapeutic index,⁷⁵ for example, cardiac drugs, anti-neoplastic agents, oral anti-diabetic drugs, and anti-coagulants; (2) when the drug requires the maintenance of specific blood levels, for example, antibiotics and anti-hypertensives; and, (3) when the drug's effect must be measured by sensitive lab parameters, for example, thyroid hormones, electrolytes, and diagnostic steroids.⁷⁶ In each of these instances, the difference in a product's bioavailability may mean the difference between effective treatment and under- or over-dosage.⁷⁷

In many chronic drug regimens, such as anti-hypertensive, anti-diabetic, anti-convulsant, or cardiac therapies, the patient's actual drug dosage will be adjusted individually until the desired effect is

⁷⁰D. CHODOS & A. DiSANTO, *supra* note 63, at 16. For examples of bio-inequivalence in specific drugs, see Arnold, Gerber & Levy, *Absorption and Dissolution Studies on Sodium Diphenylhydantoin Capsules*, 5 CAN. J. PHARM. SCI. 89 (1970) (phenytoin, an anti-convulsant); Goldfinger, *supra* note 60 (digoxin, a heart medication); Griffith & Black, *A Comparison of Blood Levels After Oral Administration of Erythrocin and Erythromycin Estolate*, 12 ANTIBIOTICS & CHEMOTHERAPY 398 (1962) (erythromycin, an antibiotic).

⁷¹See note 64 *supra*.

⁷²See 21 U.S.C. § 331(j) (1976); *United States v. Generix Drug Corp.*, 654 F.2d 1114, 1117 (5th Cir. 1981); D. CHODOS & A. DiSANTO, *supra* note 63, at 6; *Generic Deceit*, *supra* note 17, at 64; *Unapproved Generics*, *supra* note 52, at 14-16.

⁷³D. CHODOS & A. DiSANTO, *supra* note 63, at 10.

⁷⁴*Id.* at 37.

⁷⁵A drug's therapeutic index is a quantitative ratio comparing a therapeutic and an untoward effect. A low therapeutic index indicates that there is a low ratio between the dosage which will give the desired therapeutic effect and the dosages which will cause serious unwanted effects. REMINGTON'S, *supra* note 1, at 674.

⁷⁶*The Clinical Relevancy of Bioavailability*, BULL. ONT. C. PHARM. 117-18 (1972).

⁷⁷M. WEINER, BIOLOGICAL AVAILABILITY AND THE PRACTICING PHARMACIST 4-5 (1974).

achieved.⁷⁸ Once this effect is reached and maintained, the patient is said to be "stabilized on his medication."⁷⁹ If the patient changes to a product formulation that does not have the same bioavailability, he could become "unstabilized" and therefore unable to achieve the desired effect at the same dosage. Hence, the physician has an interest in ensuring that a patient is receiving the same product every time the patient renews his prescription. The pharmacist has an interest in being able to exchange sufficient information with the patient in order to ascertain exactly which product the patient has been taking.

3. *Consumers.*—Each of the foregoing interests also has an impact on the patient or ultimate consumer. The consumer-patient has an economic interest in the availability of quality drug products at reasonable prices. The presence of generic products not only results in low cost drugs, but perhaps also keeps the brand-name companies from unnecessarily inflating their prices.⁸⁰ On the other hand, consumers have an interest in receiving quality drugs and in receiving benefits from future drug research.

In light of the encouragement which patients are given to "shop around" for each prescription, it becomes increasingly important for the *patient* to be able to distinguish between competing drug products.⁸¹ The pharmacist who originally filled a given prescription will typically continue to refill the prescription with the same manufacturer's product. However, prescriptions are usually not refillable for more than one year regardless of the number of refills indicated.⁸² Therefore, even in life-long or chronic therapy a patient will be periodically given a new prescription for the same medication—a prescription which is increasingly being written using generic drug names.⁸³ Even if the patient takes a new generically written prescription to the same pharmacist, there is a substantial chance that it will be filled with a different manufacturer's product. A patient benefits if he can assist the pharmacist in identifying exactly which product he has been taking.

In addition, the consumer-patient must be able to distinguish between the products in order to protect himself from an unscrupulous pharmacist who might substitute generics for brand-

⁷⁸A.G. GILMAN, L. GOODMAN & A. GILMAN, GOODMAN & GILMAN'S THE PHARMACOLOGICAL BASIS OF THERAPEUTICS 43-48 (6th ed. 1980).

⁷⁹*See id.*

⁸⁰*But see* Cocks, *supra* note 53, at 22.

⁸¹*See* Tyler, *supra* note 23.

⁸²*E.g.*, IND. CODE § 25-26-13-25(d) (Supp. 1981).

⁸³FTC REPORT, *supra* note 4, at 45; Hecht, *supra* note 4, at 20.

name drugs, but charges for the latter.⁸⁴ Consumers should not be deprived of a means to distinguish products simply because consumers must depend upon a physician to prescribe and a pharmacist to dispense drug products.

III. JUDICIAL TREATMENT OF PHARMACEUTICAL LOOK-ALIKE CASES

The courts have become increasingly involved in balancing the interests of the parties concerned and in determining what mechanisms are to be used in differentiating drug products. The following discussion will be divided chronologically into the judicial treatment of look-alikes during the period of anti-substitution laws and the treatment after the repeal of these laws. The differing treatments given look-alike drugs during these two periods have resulted from a shift in who is deemed responsible for ensuring that consumers receive the drug products ordered. During the anti-substitution period, the burden of supplying the appropriate product was on the pharmacist; however, the repeal of these statutes has shifted more of this burden to consumers and manufacturers. This shift has been conducive to the use of trademark theories. Despite the courts' reluctance to adopt trademark theories, there appear to be possible benefits in using such an approach. Existing case law already contains aspects of trademark theories or could easily be adopted to do so.

A. Look-Alike Cases under Anti-Substitution Laws

The court decisions during the period of anti-substitution laws reflected public policy by denouncing unauthorized substitution.⁸⁵ Because pharmacists were not allowed by law to substitute, the prevention of deception was understandably directed at these professionals. Although the imitator companies were not deceiving the pharmacists as to the product's source, the use of look-alike products made it possible for the pharmacist to deceive the ultimate consumer.⁸⁶ The actual use of look-alikes was not enjoined, however. The courts merely required that the imitator company place on the label a warning to pharmacists not to substitute the product for the

⁸⁴Swenson, *Property Rights and Look-Alike Pharmaceutical Products*, U.S. PHARM., Mar. 1978, at 20, 21.

⁸⁵See *William R. Warner & Co. v. Eli Lilly & Co.*, 265 U.S. 526 (1924); *Upjohn Co. v. Schwartz*, 246 F.2d 254 (2d Cir. 1957); *Smith, Kline & French Laboratories v. Clark & Clark*, 157 F.2d 725 (3d Cir.), *cert. denied*, 329 U.S. 796 (1946). For a review of the early look-alike cases, see Swenson, *Property Rights in the Color and Shape of Capsules*, 32 FOOD DRUG COSM. L.J. 361 (1977).

⁸⁶See, e.g., *William R. Warner & Co.*, 265 U.S. at 530-32.

innovator's product.⁸⁷ Before the innovator company could obtain even this token relief, however, it had to show either that its product's nonfunctional shape and color had acquired a secondary meaning and that the imitator's product was likely to cause confusion, or that the defendant had either actively or inferentially induced the palming off of its product.⁸⁸

In one of the earliest cases, *William R. Warner & Co. v. Eli Lilly & Co.*,⁸⁹ the plaintiff-innovator Lilly failed to establish that its use of chocolate in a liquid quinine preparation was nonfunctional. The Supreme Court held that because the chocolate flavoring masked the bitter taste of quinine, its use was functional and thus could not acquire a secondary meaning for protection purposes.⁹⁰

The plaintiff was required to show that the defendant had both induced fraudulent behavior and had provided the means to implement it.⁹¹ The Court found that because the imitator-defendant had used the similar appearance and flavor to actively encourage pharmacists to substitute its product for the plaintiff's, the plaintiff had proven his case and the defendant was guilty of unfair competition practices.⁹² The Court very clearly stated, however, that the wrong was only in the unfair purposes with which the defendant had used the similarity between the products, and not in the similarity itself.⁹³

The Court in *Warner* recognized nothing more than a common law action for fraud. The resulting injunction did little more than slap the greedy hand of the imitator. If the innovator company was to obtain more satisfactory relief, however, it would be necessary to circumvent the Court's finding that a product's color was functional. That step was taken in *Smith, Kline & French Laboratories v. Heart Pharmaceutical Corp.*⁹⁴

In *Heart*, the innovator-plaintiff carried its burden of proving nonfunctionality of both the product's heart shape and color by showing that the same product had previously been marketed as a round white tablet.⁹⁵ In addition, the plaintiff introduced evidence of a deliberate and arbitrary selection of its product's new shape and

⁸⁷*Id.* at 532-33; *Upjohn Co.*, 246 F.2d at 262; *Smith, Kline & French Laboratories*, 157 F.2d at 731.

⁸⁸See *William R. Warner & Co.*, 265 U.S. at 530; *Upjohn Co.*, 246 F.2d at 257-61; *Smith, Kline & French Laboratories*, 157 F.2d at 729-31.

⁸⁹265 U.S. 526 (1924).

⁹⁰*Id.* at 529. *But see* Cooper, *supra* note 37, at 9-11.

⁹¹265 U.S. at 530-31.

⁹²*Id.* at 529-30.

⁹³*Id.* at 532.

⁹⁴90 F. Supp. 976, 978 (S.D.N.Y. 1950). Compare *id.* with *Smith, Kline & French Laboratories*, 157 F.2d at 731.

⁹⁵90 F. Supp. at 977.

color, as well as evidence of the large amounts of money it had spent on promoting the product's new appearance.⁹⁶ Although the court recognized that this new appearance had acquired a secondary meaning for both the professional consumer and the ultimate consumer,⁹⁷ it nevertheless based its decision upon a common law action for palming off.⁹⁸

Although ostensibly applying the same test used in *Warner* to sustain an unfair competition action based on common law fraud, the court in *Heart* broadened the test's application.⁹⁹ Unlike in *Warner*, the plaintiff in *Heart* presented no evidence that the defendants had actually induced the pharmacists to substitute their products for the plaintiff's, although specific instances of pharmacists palming off were shown. Nonetheless, the court reasoned that "the practical effect of the defendants' advertisements and the use of the term 'Color Guaranteed' "¹⁰⁰ left no other conclusion than that the defendants had intended pharmacists to use their products as substitutes.¹⁰¹ The court therefore enjoined the defendants from continuing to market their drug products as look-alikes.¹⁰²

The test used in *Warner* was again expanded in *Upjohn Co. v. Schwartz*,¹⁰³ to grant relief in those cases where actual instances of palming off had not been shown. The court held that it was sufficient if the circumstances surrounding the defendant's use and promotion of its look-alike products had made it reasonable to anticipate that confusion with the plaintiff's products would result.¹⁰⁴ The court stated that a "suggestion . . . of the possibility of substitution . . . was itself unfair"¹⁰⁵ and that it was unnecessary for the plaintiff to show that pharmacists "did what defendant had made it possible for them to do."¹⁰⁶ Although the test in this form appears to be the same test utilized to discern liability in trademark infringement at common law,¹⁰⁷ the plaintiff did not prove that the colors and shapes of its various tablets had acquired the requisite secondary meaning necessary for protection as trademarks.¹⁰⁸ The court did find,

⁹⁶*Id.*

⁹⁷*Id.*

⁹⁸*Id.* at 978.

⁹⁹*Id.* (quoting 265 U.S. at 530-31).

¹⁰⁰90 F. Supp. at 978.

¹⁰¹*Id.*

¹⁰²*Id.*

¹⁰³246 F.2d 254 (2d Cir. 1957).

¹⁰⁴*Id.* at 258.

¹⁰⁵*Id.*

¹⁰⁶*Id.*

¹⁰⁷See Lanham Act § 2(f), 15 U.S.C. § 1052(f) (1976).

¹⁰⁸246 F.2d at 257.

however, that proof of the "likelihood of confusion" coupled with the defendant's affirmative activities,¹⁰⁹ supported an unfair competition action based on palming off.¹¹⁰ The defendant was enjoined from suggesting that its product be used as a substitute and was required to include a statement to that effect on its products' labels.¹¹¹ Schwartz, however, was not enjoined from actually marketing look-alike products.¹¹²

These decisions are representative of the limited relief that the innovator-plaintiffs could expect under anti-substitution laws. Generally, a warning not to substitute the imitator's product, coupled with the threat of serious administrative and statutory sanctions,¹¹³ were considered sufficient to deter unlawful substitution by pharmacists. Under the anti-substitution laws, it was the pharmacist, aided by the manufacturer's look-alikes, who deceived the public. Thus, it may have been logical, if not totally satisfactory, to limit the plaintiff's relief to a warning label directed at the pharmacist. If the plaintiff could prove that its product's appearance had acquired a secondary meaning, however, then the imitators were held more responsible for the actual deception of the public, and therefore, more likely to be enjoined from producing look-alikes.¹¹⁴ The consumer in that instance relied not only upon the pharmacist's ethics in dispensing the appropriate drug product, but also upon his own knowledge concerning the product's appearance to assure himself that he had received the correct product.

As long as the anti-substitution laws were in effect, the traditional equitable interests, which were considered in deciding whether the plaintiff was entitled to an injunction prohibiting look-alikes, generally balanced out against granting the relief.¹¹⁵ The public's health interests were considered adequately protected by the anti-substitution laws, and the public's interest in free competition appeared to outweigh the plaintiff's loss.

Once the repeal of anti-substitution laws began and the pharmacists were no longer faced with sanctions for merely substituting, the equitable balance began tipping in the plaintiff's favor.¹¹⁶ As the

¹⁰⁹*Id.* at 261. The defendant not only marketed look-alike drug products but provided pharmacists with color charts as substitution guides and actively suggested that pharmacists substitute the products. *Id.* at 259-61.

¹¹⁰*Id.* at 261-62.

¹¹¹*Id.* at 262.

¹¹²*Id.*

¹¹³*See, e.g., PMA, supra* note 9, at 6; REMINGTON'S, *supra* note 1, at 27.

¹¹⁴*See Smith, Kline & French Laboratories*, 90 F. Supp. at 977-78.

¹¹⁵*See William R. Warner & Co.*, 265 U.S. at 531-33; *Upjohn Co.*, 246 F.2d at 258-62; *Smith, Kline & French Laboratories*, 157 F.2d at 731.

¹¹⁶*See Ives Laboratories, Inc. v. Darby Drug Co.*, 638 F.2d 538 (2d Cir.), *rev'd*

courts' views toward look-alikes changed in keeping with the theories underlying substitution laws, the extent of judicial remedies also changed.

B. Look-Alike Cases under Substitution Laws

The recent court decisions affecting look-alike drug products continue to be concerned with assuring the public that illegal substitution or palming off does not occur. However, the distinction between the promotion of lawful substitution and the unfair practice of palming off is often muddled by the use of look-alikes.

The courts still require proof of actual instances of palming off that are either actively or implicitly induced by the defendant,¹¹⁷ or in the alternative, proof that the appearance of the innovator's product has attained common law trademark status before the defendant's product entered the market.¹¹⁸ The difficulty in proving the latter¹¹⁹ has resulted in the majority of injunctions being granted, as before, upon proof of palming off.¹²⁰ Recently, proof of palming off has generally been predicated upon an implied rather than an active inducement by the defendant. This trend can be attributed to the generic companies' increased reliance on catalogs rather than detail men. Additional changes can be seen in an apparent tipping of the equity interest balance in the plaintiff's favor which has resulted in the granting of more satisfactory injunctions. These changes are easily recognized in *Pennwalt Corp. v. Zenith Laboratories, Inc.*,¹²¹ a

and remanded sub nom. *Inwood Laboratories, Inc. v. Ives Laboratories, Inc.*, 50 U.S.L.W. 4592 (1982); *SK & F, Co. v. Premo Pharmaceutical Laboratories, Inc.*, 481 F. Supp. 1184 (D.N.J. 1979), *aff'd*, 625 F.2d 1055 (3d Cir. 1980); *Pennwalt Corp. v. Zenith Laboratories, Inc.*, 472 F. Supp. 413 (E.D. Mich. 1979), *appeal dismissed mem.*, 615 F.2d 1362 (6th Cir. 1980).

¹¹⁷*See Ives Laboratories, Inc. v. Darby Drug Co.*, 638 F.2d 538, 542-43 (2d Cir.), *rev'd and remanded sub nom. Inwood Laboratories, Inc. v. Ives Laboratories, Inc.*, 50 U.S.L.W. 4592 (1982); *SK & F, Co. v. Premo Pharmaceutical Laboratories, Inc.*, 481 F. Supp. 1184, 1187-88 (D.N.J. 1979), *aff'd*, 625 F.2d 1055, 1063-64 (3d Cir. 1980); *Pennwalt Corp. v. Zenith Laboratories, Inc.*, 472 F. Supp. 413, 418-20 (E.D. Mich. 1979), *appeal dismissed mem.*, 615 F.2d 1362 (6th Cir. 1980); *Marion Laboratories, Inc. v. Michigan Pharmacal Corp.*, 338 F. Supp. 762, 769-70 (E.D. Mich. 1972), *aff'd mem.*, 473 F.2d 910 (6th Cir. 1973).

¹¹⁸*SK&F, Co. v. Premo Pharmaceutical Laboratories, Inc.*, 481 F. Supp. 1184, 1188 (D.N.J. 1979), *aff'd*, 625 F.2d 1055, 1063-64 (3d Cir. 1980); *Marion Laboratories, Inc. v. Michigan Pharmacal Corp.*, 338 F. Supp. 762, 769 (E.D. Mich. 1972) *aff'd mem.*, 473 F.2d 910 (6th Cir. 1973).

¹¹⁹*See notes 32-34 supra* and accompanying text.

¹²⁰*See, e.g., SK&F, Co. v. Premo Pharmaceutical Laboratories, Inc.*, 625 F.2d 1055, 1063 (3d Cir. 1980); *Pennwalt Corp. v. Zenith Laboratories, Inc.*, 472 F. Supp. 413, 418-20 (E.D. Mich. 1979), *appeal dismissed mem.*, 615 F.2d 1362 (6th Cir. 1980).

¹²¹472 F. Supp. 413 (E.D. Mich. 1979), *appeal dismissed mem.*, 615 F.2d 1362 (6th Cir. 1980).

case decided not long after the effective repeal of Michigan's anti-substitution law.¹²²

In *Pennwalt*, the trial court employed a subjective-objective test requiring the plaintiff to prove that the defendant knew or should have known from the circumstances that its product was likely to be used deceptively.¹²³ The court granted the plaintiff, Pennwalt, an injunction prohibiting Zenith from selling its look-alike product to pharmacists¹²⁴ even though there was no evidence that Zenith itself had palmed off its product.¹²⁵ The district court found that because Pennwalt's product was the resin form of the drug phentermine and Zenith's product was the generically inequivalent hydrochloride salt form, a substitution of one product for the other was a violation of the Michigan substitution law.¹²⁶ Despite this generic inequality, Zenith had distributed catalogs which included statements in the products' descriptions which indicated that its products were "[s]imilar [t]o" competing brand name products and implying that they were also generic equivalents.¹²⁷ The court reasoned that these circumstances coupled with the fact that Zenith deliberately chose the identical color scheme of Pennwalt's product, had created a situation which Zenith should have reasonably anticipated would, and did, lead to deception or confusion.¹²⁸

In applying the traditional equity tests involved in any injunctive request, the court stated that the public's interest in obtaining equivalent therapeutic effects from substituted drugs outweighed the public's interest in benefiting from the substitution of a less expensive product.¹²⁹ The court also indicated that the balance of equitable interests tipped heavily in favor of maintaining the integrity of the drug substitution guidelines and that these policies would be undermined if Zenith were allowed to continue marketing a look-alike product that was not generically equivalent.¹³⁰

In *SK&F, Co. v. Premo Pharmaceutical Laboratories, Inc.*,¹³¹ the actual inequality between the two drug products again played an im-

¹²²The Michigan statute prohibiting substitution, MICH. COMP. LAWS § 338.1117(l) (1970), was never actually repealed. Instead, additional code sections were added which re-defined "substitution," MICH. COMP. LAWS ANN. § 338.1101(u) (1980), and allowed substitution of generic products, *id.* § 338.1114(a). See Note, *Improving Michigan's Generic Drug Laws*, 9 U. MICH. J.L. REF. 394 (1975-76).

¹²³472 F. Supp. at 420.

¹²⁴*Id.* at 423.

¹²⁵*Id.* at 419.

¹²⁶*Id.* at 416-17, 419.

¹²⁷*Id.* at 416.

¹²⁸*Id.* at 420.

¹²⁹*Id.* at 423.

¹³⁰*Id.*

¹³¹481 F. Supp. 1184 (D.N.J. 1979), *aff'd*, 625 F.2d 1055 (3d Cir. 1980).

portant role in the ultimate balancing of the equitable interests. In *Premo*, the defendant Premo's product was shown to have a higher bioavailability than did the plaintiff SK&F's product, Dyazide.¹³² Although the two products might properly have been termed "generic equivalents" because they contained the same two active ingredients,¹³³ they were not bioequivalent.¹³⁴ Because Premo's product provided higher blood levels than a physician would have expected when prescribing Dyazide,¹³⁵ the two products were not safely interchangeable as required by the theories underlying substitution. It was therefore not in the public's best interests to facilitate their substitution.¹³⁶

The trial court granted SK&F an injunction prohibiting Premo from continuing to market its Dyazide look-alike. It based its decision both on findings that SK&F had sufficiently established that the maroon and white capsule arbitrarily chosen for Dyazide had acquired a secondary meaning¹³⁷ and that Premo's argument in defense of its deliberate imitation was "calculated to encourage fraud and deception."¹³⁸

By following the reasoning of the *Premo* court, the production of look-alike products could be enjoined even without a basic inequality between the products—as long as the product's appearance had acquired secondary meaning. But without either factor—a basic inequality of products or a showing of secondary meaning—the question whether to grant an injunction becomes much more difficult. The question in this form, stripped of the weighted inequality factors, is the essential issue presented by the look-alike controversy. The issue in this form has finally been addressed in *Ives Laboratories, Inc. v. Darby Drug Co.*¹³⁹ An examination of the district and appellate court decisions reveal the difficulty courts have in balancing the equities when presented with the "pure" form of this issue.

In *Ives*, the plaintiff Ives had marketed its patented cyclandelate product under the brand-name of Cyclospasmol in blue

¹³²481 F. Supp. at 1190; 625 F.2d at 1061.

¹³³Both products contained 50 mg. of triamterene and 25 mg. of hydrochlorthiazide. 481 F. Supp. at 1187.

¹³⁴*Id.* at 1190.

¹³⁵*Id.* The FDA recalled Premo's product on February 11, 1980. Studies showed that because Premo's product had a greater absolute bioavailability than did Dyazide, it could cause hyperkalemia, a toxic buildup of potassium. 625 F.2d at 1061 n.4.

¹³⁶481 F. Supp. at 1090-91.

¹³⁷*Id.* at 1188.

¹³⁸*Id.*

¹³⁹455 F. Supp. 939, 945 (E.D.N.Y. 1978), *aff'd and remanded*, 601 F.2d 631 (2d Cir. 1979); 488 F. Supp. 394 (E.D.N.Y. 1980), *rev'd and remanded*, 638 F.2d 538 (2d Cir.), *rev'd and remanded sub nom.* Inwood Laboratories, Inc. v. Ives Laboratories, Inc., 50 U.S.L.W. 4592, (1982).

or combination blue and red capsules¹⁴⁰ for some years. When Ives' patent on the drug cyclandelate expired in 1972, several manufacturers began marketing generic versions in variously colored capsules. The defendant manufacturers and wholesalers chose to market their generic products in capsules of the same size and color as the Ives product. Although Ives convinced the Second Circuit that an injunction was warranted which prohibited the defendant from marketing look-alike products,¹⁴¹ the plaintiff not only had a more difficult time establishing that the equities were balanced in its favor, but also that the defendants had contributed to the instances of actual palming off.

The district court refused to grant Ives an injunction because it found that the defendants' practice of listing or comparing their products with the trademark products¹⁴² was not designed to suggest that pharmacists illegally substitute.¹⁴³ The court instead held that any illegal substitution was caused by the pharmacists' misunderstanding of the New York substitution laws.¹⁴⁴ Those substitution laws required the pharmacist to place the manufacturer's name, in addition to the substituted drug's generic name, on the prescription label.¹⁴⁵ Because the defendants' products were equivalent, both generically and in terms of bioavailability,¹⁴⁶ the district court reasoned that the defendants' promotional catalogs could not be construed to suggest *illegal* substitutions.¹⁴⁷ In other words, the catalogs were not construed as suggesting that pharmacists mislabel the substituted drug product as "Cyclospasmol" rather than use the appropriate labeling "cyclandelate—X manufacturer." The court of appeals reversed the district court and in recommending that the requested injunction be granted, stated that the catalogs, coupled with the lower prices of the defendants' products and their identical appearance to Cyclospasmol, impliedly suggested that pharmacists illegally substitute the products.¹⁴⁸

¹⁴⁰Ives marketed Cyclospasmol 200 mg. in pale blue capsules and Cyclospasmol 400 mg. in red and blue capsules. 455 F. Supp. at 941.

¹⁴¹638 F.2d at 544. This injunction, however, has yet to be imposed pending resolution of an appeal to the Supreme Court.

¹⁴²488 F. Supp. at 396.

¹⁴³*Id.* at 397.

¹⁴⁴*Id.*

¹⁴⁵N.Y. EDUC. LAW § 6816-a(1)(c) (McKinney Supp. 1981-1982).

¹⁴⁶488 F. Supp. at 396.

¹⁴⁷*Id.* at 397.

¹⁴⁸638 F.2d at 543-44. The ruling of the court of appeals dealt strictly with the section 32 claim of contributory infringement. The court did not rule on either the section 43(a) claim nor on the issue of secondary meaning. *Id.* at 539-40. Therefore, even if the generic manufacturers are successful in their appeal to the Supreme Court, the trademark companies will have lost little if any ground. The court's contributory

Although not discussed by the court of appeals, there is another important aspect of the district court's opinion. The district court had also denied relief regarding Ives' claim that the defendants had infringed upon its common law trademark, on the grounds that there was insufficient evidence to show that Cyclospasmol's appearance had acquired a secondary meaning.¹⁴⁹ In fact, the district court pointed out that the very nature of a pharmaceutical product made it extremely difficult to prove secondary meaning, primarily because the promotional advertising is not aimed at the ultimate consumer.¹⁵⁰ This reasoning is unsatisfactory in light of the guidelines for recognizing secondary meaning in pharmaceutical products as set forth by Justice Learned Hand in *Bayer Co. v. United Drug Co.*,¹⁵¹ a case quoted by the district court in its discussion of secondary meaning.¹⁵²

In *Bayer*, the defendant company was enjoined from selling its product, labeled only as "aspirin," to manufacturing chemists, physicians, and pharmacists. However, the defendant was allowed to label its product merely as "aspirin" when selling it directly to the public.¹⁵³ The court reasoned that because the professional-level consumer had been educated to understand that "aspirin" was only a tradename identifying the particular source of the drug acetyl salicylic acid, the word "aspirin" deserved protection with reference to these consumers.¹⁵⁴ The public, however, had come to recognize the drug itself only by the word "aspirin," and made no connection between the word and the plaintiff. Therefore, the word did not deserve the same protection with reference to this group.¹⁵⁵

The *Ives* court failed to recognize that an analogy exists between the name factor in *Bayer* and the color situation in the look-alike cases. Physicians and pharmacists in the look-alike cases have additional information regarding source afforded by the manufacturers' various package dressings and advertisements, just as the professional level consumers in *Bayer* had been educated as to the true meaning of "aspirin." The consumers in the look-alike cases, however, know the tablet or capsule only by its color, much as the public in *Bayer* knew the drug only by the word "aspirin," and

infringement ruling is more reminiscent of cases decided during the anti-substitution era. Compare *id.* with the cases cited in notes 85 & 117-18 *supra*.

¹⁴⁹488 F. Supp. at 400-01. See note 148 *supra*.

¹⁵⁰488 F. Supp. at 401.

¹⁵¹272 F. 505 (S.D.N.Y. 1921).

¹⁵²488 F. Supp. at 400 (quoting 272 F. at 509-10).

¹⁵³272 F. at 514-15.

¹⁵⁴*Id.* at 513-14.

¹⁵⁵Compare the relief granted in *Bayer*, 272 F. at 514-15, with the limited injunction issued in *Pennwalt Corp.*, 472 F. Supp. at 422-24.

should therefore be treated in accordance with this relationship. It is important to realize that the various factors involved, such as advertising and color recognition, cannot be summarily lumped together, but rather must be carefully scrutinized and accorded their proper relationships within the interests of the two consumer groups. The district court in *Ives* failed to assign the proper relationships of colors and drug products as used by the ultimate consumer.

Although the district court did acknowledge that patients do identify their medications by color,¹⁵⁶ the court stopped short of fully applying the reasoning of *Bayer*. The court implied that patients only associate the color of their medication with the *class* of drug and not with the *source* of the drug.¹⁵⁷ Using the district court's reasoning, secondary meaning does not attach unless the patient first associates the red and blue capsules with the *brand-name* Cyclospasmol, and *then* associates that name with a single, although anonymous, source.¹⁵⁸

This interpretation incorporates a second association step in the traditional concept of secondary meaning. Regardless of whether the patient knows the name of his specific medication, or even who the actual manufacturer is, the medication's color has acquired a secondary meaning for him. Rather than the patient associating the capsule's color with a particular drug *class*, he probably associates the color with a particular drug *product* within the class. For example, if the patient knows that he has been taking a heart medication and that his *specific* medication is a red and blue capsule, he feels safe in assuming that he will always receive the same particular medication when he takes a red and blue capsule for his heart. Under the district court's reasoning, the patient would expect *all* heart medications to be in red and blue capsules, not just a particular one. That is clearly not how colors are associated with drug products in which the color is nonfunctional.

Using this rationale, it is easy to see how trademark theories can be utilized. The consumer must be afforded a means by which to distinguish goods. If he can only differentiate between products by the combination of their nonfunctional shape and color, that means should be made available to him.¹⁵⁹ Although the look-alike cases have not been specifically decided on trademark grounds, the various aspects of the theory have pervaded the decisions.

¹⁵⁶488 F. Supp. at 400.

¹⁵⁷*Id.*

¹⁵⁸*Id.*

¹⁵⁹See *Ex parte* Nuodex Prods. Co., 107 U.S.P.Q. (BNA) 300 (Dec. Comm'r Pat. 1955); *Ex parte* Oscar Mayer & Co., 47 U.S.P.Q. (BNA) 234 (Dec. Comm'r Pat. 1940). See also *In re* Swift & Co., 223 F.2d 950 (C.C.P.A. 1955).

IV. PROPOSAL

With the advent of pro-substitution laws, courts have been more willing to enjoin the production of look-alike products. However, the courts have not yet gone far enough. The district court in *Premo* recognized that "[p]rophylaxis is not only a medical term. It is also a legal term expressing methods for preventing intentional or accidental violations of the law."¹⁶⁰ Although an injunction is prophylactic in the sense that it prevents offensive conduct from continuing, it is merely remedial in the sense that the offensive conduct must first have occurred. In the case of drug products, this requirement of prior misconduct may prove very costly.¹⁶¹

The underlying goal governing the relationship between brand-name and generic drug products should be the same as with any other product, that is, to let the consumer know what he is receiving. The effectiveness of the three possible mechanisms for satisfying this goal, as discussed or utilized by the courts, can be easily compared in terms of the predictability of obtaining the desired result and the satisfaction of legitimate interests.

A. *Comparison of Mechanisms*

1. *Anti-Substitution Laws.*—The anti-substitution laws provided the consumer, as well as the professionals and manufacturers, with a high degree of predictability. Because it was illegal to substitute one product for another,¹⁶² the consumer was reasonably assured of

¹⁶⁰*SK&F, Co. v. Premo Pharmaceutical Laboratories, Inc.*, 481 F. Supp. 1184, 1189 (D.N.J. 1979), *aff'd*, 625 F.2d 1055 (3d Cir. 1980).

¹⁶¹*See, e.g., SK&F, Co. v. Premo Pharmaceutical Laboratories, Inc.*, 625 F.2d 1055, 1061 n.4 (3d Cir. 1980); *Pennwalt Corp. v. Zenith Laboratories, Inc.*, 472 F.Supp. 413, 416-17 (E.D. Mich. 1979), *appeal dismissed mem.*, 615 F.2d 1362 (6th Cir. 1980). *See also* Jordan, *CNS Stimulants Sold as Amphetamines*, 38 AM. J. HOSP. PHARM. 29 (1981) (letter); Passe, *Pill Pourri*, 4 STREET PHARMACOLOGIST 6 (1981); Indianapolis Star, Apr. 2, 1982, at 4, col. 1.

For example, amphetamine "look-alikes" are being legally sold on the street. However, these "look-alikes," unlike the type focused upon in this Note, are products dressed up to look like a brand-name amphetamine, but do not contain any amphetamines. Generally, they contain caffeine and either ephedrine or phenylpropanolamine which are commonly used as antihistamines and decongestants. These imposter drugs are available in nonprescription strengths and are advertised in various "underground" magazines and newspapers as "legal stimulants." Although these drugs do affect the central nervous system (CNS), they are extremely weak compared to the drugs they look like. However, the combined effect of the substituted ingredients is unpredictable and deaths have been attributed to their use. Therefore, this particular type of look-alike is very dangerous—for both the amphetamine user who unknowingly takes an imposter and for the regular user of the imposter who mistakenly takes the same number of real amphetamines.

¹⁶²*See* notes 13-15 *supra* and accompanying text.

receiving the precise drug which his physician prescribed. Both the physician and the pharmacist benefited from this predictability. The physician knew and controlled the exact medications his patients received; the pharmacist knew exactly which product to dispense and knew the consequences if he substituted.

Anti-substitution laws did not, however, adequately satisfy the interests of these parties. Although satisfying the consumer's need for reliable identification, the laws frustrated the consumer's interest in receiving less expensive health care. Anti-substitution laws protected the good will and property interests of the brand-name companies, but unnecessarily hindered the public's interest in free competition.¹⁶³ A more refined technique was needed to allow consumers the economic benefits offered by generic products, but also designed to protect consumers from unscrupulous pharmacists, and manufacturers.

2. *Pro-Substitution Laws.*—The pro-substitution laws resulted in lower priced generics for consumers. However, they also decreased the degree of conduct predictability previously enjoyed under the anti-substitution laws. Because pharmacists are now allowed to substitute,¹⁶⁴ the physician and consumer are no longer assured that the patient will receive the precise drug ordered. The consumer has been forced to take a more active role in identifying and monitoring the specific drug product received.¹⁶⁵

These laws, although making generic products more accessible, have created a system within pharmacy which is more conducive to problems of palming off whether inadvertent or intentional.¹⁶⁶ These laws and the FDA have encouraged pharmacists to substitute; however, substitution also makes the pharmacist more vulnerable to consumer lawsuits if adverse reactions occur.¹⁶⁷ In addition, if substitution occurs, the present difficulty in generating sufficient bioavailability data lessens the assurance that the patient will

¹⁶³See generally *William R. Warner & Co. v. Eli Lilly & Co.*, 265 U.S. 526, 529-32 (1924); *Upjohn Co. v. Schwartz*, 246 F.2d 254, 258, 261-62 (2d Cir. 1957); *Smith, Kline & French Laboratories v. Clark & Clark*, 157 F.2d 725, 731 (3d Cir.), *cert. denied*, 329 U.S. 796 (1946); *Smith, Kline & French Laboratories v. Heart Pharmaceutical Corp.*, 90 F. Supp. 976, 977-78 (S.D.N.Y. 1950).

¹⁶⁴See notes 17-27 *supra* and accompanying text.

¹⁶⁵See notes 80-84 *supra* and accompanying text.

¹⁶⁶See generally *Ives Laboratories, Inc. v. Darby Drug Co.*, 488 F. Supp. 394 (E.D.N.Y. 1980), *rev'd and remanded*, 638 F.2d 538 (2d Cir.), *rev'd and remanded sub nom.* *Inwood Laboratories, Inc. v. Ives Laboratories, Inc.* 50 U.S.L.W. 4592 (1982); PMA, *supra* note 9, at 5.

¹⁶⁷*Generic Deceit*, *supra* note 17, at 65.

receive a drug equivalent in quality to one prescribed by his physician.¹⁶⁸

The generic companies' interest in breaking into the drug market was well met. Pro-substitution laws typically require that if a substitution is made, a pharmacist must substitute a less expensive product.¹⁶⁹ However, this approach swings the pendulum too far, because the brand-name companies receive little support for their products in the pro-substitution laws. The presumption that a substitution was the result of palming off no longer operates in the brand-name companies' favor. The presumption has shifted to one which requires the brand-name companies to rebut the assertion that the substitution was lawful and in good faith.

3. *Trademark Theories.*—Although the courts have fallen short of adopting trademark theories in relation to the look-alike drug cases, these theories are particularly applicable. The look-alike drug issue includes four primary interests: (1) to provide consumers with an opportunity for less expensive drug products; (2) to provide the consumer with a reasonable means of identifying the actual product received; (3) to protect the generic drug companies' opportunity to engage in free competition; and, (4) to protect the good will and investments of the brand-name companies. Each of these interests is adequately satisfied by the use of trademarks.

Trademarks afford a means within a freely competitive market to distinguish among similar products. The marks also protect a company's good will and reputation for quality because courts will enjoin the unauthorized use of a recognized trademark.¹⁷⁰ There is also a high degree of conduct predictability associated with a mark's use because the mark is recognized as a symbol of the product's source and identity. The manufacturers can rely on judicial protection of their trademarks and consumers can rely on the marks as a means of product identification. If the mark is registered,¹⁷¹ then notice has effectively been given to potential infringers.¹⁷² Thus infringement and, in the case of look-alikes, deception can be curtailed before it begins and the harm is done.

¹⁶⁸See generally Davis, *Substitution Means Poor Therapy*, PRIVATE PRAC., May 1978, at 9; Tyler, *supra* note 23, at 454; *The Priceless Ingredient*, 70 J. IND. ST. MED. A. 455 (1980).

¹⁶⁹See Tyler, *supra* note 23, at 455-57; see also Goldberg & DeVito, *supra* note 11, at 75; *Drug Substitution: Where Does Your State Stand?*, NARD J., Oct. 1980, at 44; Note, *supra* note 11, at 395-406; *Overview*, *supra* note 11, at 15.

¹⁷⁰Lanham Act §§ 32, 43(a), 15 U.S.C. §§ 1114, 1125(a) (1976).

¹⁷¹See Lanham Act §§ 1-2, 15 U.S.C. §§ 1051-1052 (1976).

¹⁷²RESEARCH INSTITUTE OF AMERICA, PREPARING FOR THE NEW TRADE-MARK LAW 9 (1946). See Lane, *A Primer for the General Practitioner on Trademarks and Unfair Competition*, 34 J. MO. BAR 86 (1978).

B. Color as a Trademark

Color can not be relied upon *alone* to provide a means of satisfying the interests of both professionals and ultimate consumers; these interests, as well as those of the manufacturers, would be served by allowing the companies to trademark the *combination* of color, size, and shape. In this way, the manufacturers would not acquire a monopoly in the size or shape or color individually, but only in reference to a single drug entity which would be sufficient to protect its investment. Consumers would be able to readily distinguish among products containing the same drug, although color could not be solely relied upon to identify the drug entity. Physicians and pharmacists would be able to converse with the patient regarding his continued medication and, if an assigned product numbering system were required, would also be able to easily and accurately identify a tablet or capsule by looking up its number on a list. The use of trademarks would also provide judicial economy because infringement action could be decided more readily. In short, the satisfaction of all aspects of conduct predictability would be increased.

The Lanham Act of 1946 does not specifically prohibit the registration of color as a trademark, and indeed, can be easily construed to permit such practice in particular circumstances.¹⁷³ However, courts have been extremely reluctant to recognize color alone as a valid trademark.¹⁷⁴ The courts' reluctance is grounded in the depletion doctrine which holds that because there are only a finite number of colors available, it would be an unfair restraint on trade to allow manufacturers to trademark, and thus deplete the available colors.¹⁷⁵

The applicability of this doctrine to drug products, however, is questionable because there are approximately sixty-one coloring agents available for drugs,¹⁷⁶ and "[b]y selective combinations of the colorants one can create unique colors for special effects such as mint green, lemon, or lime, chocolate, raspberry, wine, and others."¹⁷⁷ Even further distinctions are possible because hard

¹⁷³Cooper, *supra* note 37, at 3-7.

¹⁷⁴See, e.g., *Plastilite Corp. v. Airlite Plastics Co.*, 390 F. Supp. 1141 (D. Neb.), *rev'd*, 526 F.2d 1078 (8th Cir. 1975), *cert. denied*, 425 U.S. 938 (1976); *Plastilite Corp. v. Kassnar Imports*, 508 F.2d 824 (C.C.P.A. 1975); *In re Shaw*, 184 U.S.P.Q. (BNA) 253 (P.O.T.M. App. Bd. 1974).

¹⁷⁵A. SEIDEL, *WHAT THE GENERAL PRACTITIONER SHOULD KNOW ABOUT TRADEMARKS AND COPYRIGHTS* 109 (4th ed. 1979).

¹⁷⁶Hefferren, *Description of the Identification Guide*, 182 J. A.M.A. 1146, 1150 (1962).

¹⁷⁷H. ANSEL, *INTRODUCTION TO PHARMACEUTICAL DOSAGE FORMS* 70 (1959), *quoted in* Cooper, *supra* note 37, at 25.

gelatin capsules are composed of two separate pieces, each capable of being colored differently or left transparent.¹⁷⁸

Although tablets may present a more limited range of color distinctions due to functional considerations,¹⁷⁹ they too may take advantage of colors and color combinations. For example, a tablet may be coated with various colored dyes or have different colored layers laminated together. A tablet may be embossed or imprinted with designs or made into various shapes, including any classic geometric form as well as flattened cylinders or football shapes. If a company were required to trademark its product's color in conjunction with shape and size, there would be even less danger of depletion.

Color, shape, and size combinations alone, however, although satisfactory for consumers' interests, would not satisfy the needs of professionals. Combination trademarking would enable both the pharmacist and physician to monitor whether the patient was receiving the same product each time, but would not promote easy identification of products in emergency situations. For example, although Dyazide is the only maroon and white diuretic, there are other nondiuretics which utilize the same color combination.¹⁸⁰ Yet, Dyazide is easily identified if one of three things is also known at the time a single capsule is presented: (1) the name of the manufacturer; (2) what the drug was prescribed for; or, (3) the presence of identifying marks.¹⁸¹ Without the identifying logos "SKF" or "Dyazide," an accurate identification of the capsule cannot be made if the patient is unable to explain why he was taking the medication.¹⁸²

Even the imprinted logos become meaningless without a means, such as the *PDR*, to explain them. Many companies neither mark nor numerically code their products, and even those that do, do not always list them in the *PDR*. An imprint or a numbered code on all single dosage forms, where feasible, would certainly promote identification. In order to be completely effective, these code numbers could then be compiled in a list made available to physicians and pharmacists. Although a National Drug Code (NDC) number identifying both the manufacturer and drug is presently assigned to each

¹⁷⁸*Id.* This has been perhaps best demonstrated by a color wheel used by Eli Lilly & Co., a leading producer of empty gelatin capsules. The wheel contains forty-two colors used for capsules which may be variously combined to create over twelve thousand color combinations. *Marion Laboratories, Inc. v. Michigan Pharmacal Corp.*, 338 F. Supp. 762, 766-67 (E.D. Mich. 1972), *aff'd mem.*, 473 F.2d 910 (6th Cir. 1973).

¹⁷⁹See note 64 *supra*.

¹⁸⁰See note 69 *supra*.

¹⁸¹See Davis, note 66 *supra*.

¹⁸²But see note 186 *infra* and accompanying text.

approved drug on the market,¹⁸³ not all manufacturers imprint these numbers on their capsules or tablets.¹⁸⁴ In addition, some unscrupulous companies print confusingly similar numbers on capsules identical to brand-name drugs but which contain nonprescription drugs which are neither generically equivalent nor equally potent to the brand-name drug.¹⁸⁵ These problems are compounded by the fact that the numerical code is sometimes printed too small to be easily read by consumers.¹⁸⁶

V. CONCLUSION

There is a genuine place for quality generic drug products in a system of free competition. There should be, however, no place for unknown or inferior drug products. Look-alike drug products make it too easy to substitute unknown products for those respected and ordered, and should therefore be abolished.

Recent judicial decisions enjoining the production of look-alikes have demonstrated a willingness to protect the trust and good will established by the brand-name companies, and to protect consumers from fraudulent and dangerous substitution. However, these steps have not gone far enough. Before an injunction can be granted, the harm must have already occurred, both to the brand-name company and to the ultimate consumer. Because of the inherent danger of drugs, this can prove to be a costly prerequisite.

Even though courts have referred to basic trademark principles throughout their opinions, these theories have not been the basis for the decisions granting relief. Trademark theories are easily applicable to the look-alike drug situation, however, and should be used.¹⁸⁷ Drug companies should be allowed to trademark the combination of color, size, and shape as it pertains to their particular drug product.

¹⁸³Cobb, *The National Drug Code System: Its Purpose and Potential*, 11 HOSP. FORMULARY 593 (1976); Jacknowitz, *supra* note 67, at 113.

¹⁸⁴Jacknowitz, *supra* note 67, at 114.

¹⁸⁵See note 161 *supra*.

¹⁸⁶SK&F, Co. v. Premo Pharmaceutical Laboratories, Inc., 625 F.2d 1055, 1061 (3d Cir. 1980); Pennwalt Corp. v. Zenith Laboratories, Inc., 472 F. Supp. 413, 420 (E.D. Mich. 1979), *appeal dismissed mem.*, 615 F.2d 1362 (6th Cir. 1980).

¹⁸⁷Although the theories themselves are easily applied, a legislature would have to be extremely careful in its wording of any statute incorporating the suggestions in this Note. The definition of a "similar product" would necessarily have to be drawn very narrowly and precisely in order to prevent the erosion of traditional trademark law.

For example, at present the word "Darvon" is an exclusive and arbitrary trademark owned by Eli Lilly & Co. which identifies Lilly's formulations containing the analgesic propoxyphene hydrochloride. If, however, the legislature loosely defined "similar product," "Darvon" antibiotics could spring up, as could "Darvon" antihistamines, or even "Darvon" scabicides. And these could all be protected as long as they were not marketed in the same color, shape and size combination as Lilly's analgesic Darvon.

The doctrine of depletion, traditionally used to block the trademarking of color, is not a valid obstacle in the drug industry. Any vestiges of its applicability to drug products is outweighed by the public's need to distinguish between drug products.

The use of a product's color, size, and shape, coupled with the product's NDC number, is a logical and convenient means of distinguishing among drug products. The public's interest in free competition is not adversely affected because the generic product may still be marketed and, state law permitting, substituted. The generic drug company is only prevented from copying the color, size, and shape of its product's brand-name counterpart, thus protecting the good will and investments of the brand-name company and decreasing the opportunity for deceptive substitutions. Most importantly, the ultimate consumer will have a means of monitoring the various drug products he is given.

NINA KATHLEEN STINSON*

*B.S. Pharmacy, Butler University 1978; Registered Pharmacist, State of Indiana.

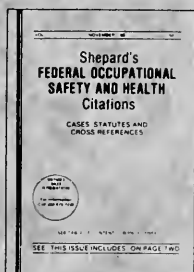
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